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H. W. BORDNER, CPA, AIA, is Assistant Comptroller for Accounting Policy in the Department of Defense. He has served as Deputy Director of the Corporation Audits Division of GAO. During the war he was with the Navy Price Adjustment Board. He was with Arthur Anderson & Co. 17 years

## *Accounting Aspects of Pricing in Negotiated Contracts*

H. W. Bordner, CPA, Ass't Comptroller, Defense Dept.

TO DISCUSS the accounting aspects of pricing negotiated contracts, it is necessary to begin with a definition of a negotiated contract. Basically a negotiated contract is any contract which is not priced upon the basis of advertising and competitive bidding, as normally required in government procurement. However, there are various types of negotiated contracts, in addition to ordinary, firm fixed-price contracts, to meet special needs, such as the cost-reimbursement type, the price-redetermination type, and the incentive type. These will be discussed later.

It is important to understand the relationship of contract price negotiation and the area of items exempt from over-all price control to appreciate some of the problems involved in price negotiations. In practice there is no simple relation between these two things although there is some correlation; the area of negotiated contracts is not identified exactly with the area of products exempt from price control.

Basically, there have been exempted from the area of price control those goods having exclusively a military use, together with all the components and parts designed solely for use in production of such military end-items.

The fact that any commodity is subject to a determinable price ceiling does not mean that contracts will be placed by the Department of Defense on the basis of such ceilings. It is a primary re-

sponsibility of procurement officers to obtain the lowest possible prices. They merely cannot pay in excess of price ceilings for items subject to price control, either under advertising for bids or under negotiated contracts.

The Department of Defense has not abandoned the policy of advertising and obtaining competitive bids as the most desirable procurement process, although in many areas it has been found necessary to resort to the more extensive use of negotiated contracts. However, as provided by the Armed Services Procurement Act the use of negotiated contracts has been common, even during normal times. For example, today it still is common practice to obtain autos and auto trucks through advertising and competitive bidding, including both those having standard specifications which are subject to price control, and combat vehicles, which are exempt from price control.

There have been occasions when advertising has been used, but did not bring forth bids that were considered to be really competitive. In such cases the bids have all been thrown out, and the military departments have proceeded to negotiate for lower prices with those submitting bids. Sometimes this procedure has not been fully understood, and there has been some confusion in the minds of the contractors concerned, with consequent criticism of this process. This misunderstanding arises from failure to understand

that the competitive bidding process was discarded as unsuccessful before commencing the negotiation process.

It is common practice where the bids have been thrown out to disclose one person's bid to another in order to negotiate lower contract prices. It does not seem to me that this is unethical so long as one contractor's cost estimates are not disclosed to another. No contractor is compelled to take a government contract so long as he has materials and a good market for his products, and in such cases the procurement officer often finds it difficult to negotiate reasonable prices. He needs to use every fair means at his disposal to attain this objective.

In negotiating contract prices, including prices for those items subject to price control, cost accounting plays an important part, but there are other means, useful in different degree in different cases, for the procurement officers' use in obtaining reasonable prices. Without going into these exhaustively, a few may be mentioned. Certain products, such as clothing, have been produced in plants operated by the military departments, under pilot operations, for the purposes of aiding production design, especially from the standpoint of production speed and economy, and of obtaining a thorough knowledge of manufacturing costs. In other instances, relative price quotations obtained informally from several sources, knowledge of a contractor's previous prices, or the continuous price history of an item, provide useful information. It is not the purpose here to deal with all the tools a contracting officer has at his disposal for purposes of contract negotiation, but merely to indicate that tools other than cost accounting are used.

Cost accounting has utility in assisting a contracting officer to negotiate prices in proportion to the failure of all other means. Sometimes it provides almost a sole basis for price determination, but in other cases it provides only one factor of several. This use of accounting in pricing negotiated contracts is the aspect of greatest interest to accountants.

One should never lose sight of the fact that a negotiated price must provide for

a profit to a contractor as well as for a return of his costs. The entire price should be such as to provide the greatest incentive to a contractor to reduce his costs and his over-all prices. Other objectives which must be solved in negotiating contracts include quality of product, attainment of speed of delivery required, and providing continuity of operation of key facilities so they will be available in event of all-out mobilization.

There has been a dearth of written material on the subject of profit allowances. More has been written on this subject in connection with renegotiation of contracts than with respect to initial contract pricing. However, all that has been said with respect to the factors to be considered in determining the reasonableness of over-all profits in renegotiation applies also in the initial pricing of individual contracts. You will recall that these factors, according to the Renegotiation Act, include interest on the capital investment; allowance for risks of loss of capital, cost changes, product guarantees, etc.; reward for efficiency and low production costs; complexity of the product; the character of the industry, with special reference to value added in production to the cost of the materials, as distinguished from mere merchandising; and the contractor's general production and delivery performance. The combination of these factors in any individual instance is an extremely difficult matter and can never be made the basis of formula. The complexity of this problem of profit allowances explains why the Department of Defense has not yet published Section XVI of the Armed Services Procurement Regulations on this all-important subject for the information of contractors, as well as for the guidance of contracting officers.

At this point I wish to point out that one essential principle in initial pricing of negotiated contracts is that each contract should stand on its own feet. If a contractor is to be compensated for risk-taking at all, there should be no consideration at the time of making a new contract for compensating him for a loss sustained on some previous contract.

It is sometimes wondered by the public

whether it would not be simpler and more economical for the government to permit loose initial pricing practices and then force more attention on the recovery of excessive profits in renegotiation. The Department of Defense opposes this view, as does the Congress. Letting down the bars in such a manner in the initial pricing process would contribute to great laxity in production practices with waste and extravagance that would only result in greater net prices to the government, even after renegotiation. The process of initial pricing must be approached with sincerity and earnestness in every contract negotiation.

The outright, firm fixed-price contract is favored by the Department of Defense over other types of negotiated contracts. However, where the lack of production or cost experience of a contractor is inadequate to permit the initial determination of a fixed price or where the existence of other large indeterminate risks would require otherwise the allowance of a substantial element of contingencies to compensate for the risk, the government stands ready and prefers to take the risk through offering a cost-reimbursement type of contract or a price-redetermination clause under a contract nominally called a fixed-price contract.

One factor in the negotiation of the outright, firm fixed-price contract is a breakdown of a contractor's cost estimates. Wherever a contractor has a standard cost system, the use of such standards based upon bills of material and time studies are especially valuable. Even where the method of making cost estimates is not related to a standard cost system, the reliability of the cost estimates may not be great unless the estimates have been made with the use of bills of materials and time studies. Actual cost experience under job-cost or process-cost accounting systems have their place where standard costs are not available, although it will be appreciated that such costs do not provide as much assurance as to their reasonableness as do standard costs.

The price-redetermination clause permits subsequent adjustment of an initial fixed price based upon the attainment of

actual cost experience during performance of the contract. Such redeterminations may be based upon analyses of actual cost at more than one stage during the contract. In general, it is provided that price redetermination always result in price reductions, but it is possible by specific contract terms to provide for increases as well. Therefore, it is a usual practice to set the initial price high enough to take care of all contingencies.

It will be appreciated that a price-redetermination arrangement eliminates certain risks which would be sustained under a firm fixed-price contract. To this extent the contractor is not entitled under a price-redetermination clause to as large a profit allowance as a factor in determining the entire price. In this connection the timing of redetermination is significant in reducing the risk; for example, a price redetermination near the time of completion of the contract would remove practically all risks.

Price redetermination clauses are used very extensively today. They have tended to supersede the cost-plus-fixed-fee contract. Although its objectives are the same as the cost-reimbursement type of contract, it has certain advantages. Among the advantages are greater flexibility in recognizing and allowing for all factors that should be considered in determining a reasonable profit margin, and the reduction of contract auditing, with elimination of the power of the Comptroller General to make disallowances of contract costs because costs are merely one factor in the determination of the entire price by agreement between the contractor and contracting officer. From the standpoint of the government a disadvantage of the price-redetermination clause, as compared with the fixed-price contract, is that it reduces the bargaining power of the contracting officer to some extent.

In principle it should be noted that the use of historical costs in price redeterminations should be tempered to allow for predicted costs during the remainder of the contract, considering cost trends and all the production factors which will have a bearing upon subsequent costs. In this respect the use of the price-redetermi-



nation clause is different than the use of the cost-reimbursement type contract.

A modification of the price-redetermination clause to provide, in principle, certain incentives to contractors to reduce prices, based upon possible cost reductions, is the incentive-type contract. From the standpoint of the government, this type of contract depends for its success upon the predetermination of a reasonable cost "target," because cost savings with respect to the target are shared by the government and the contractor. If the goal is set too high, a contractor will realize excessive profits not warranted by its actual cost performance. On the other hand, if the goal is set too low, while it may have the effect of creating pressure on the contractor for low costs, it may reward him inadequately for his efforts. The incentive-type contract requires, then, consideration of actual costs of production upon completion of the contract, as well as the cost target before beginning the contract.

Least favored of all types of negotiated contracts is the cost-reimbursement type of contract, the principal form of which is known as the cost-plus-fixed-fee contract, so familiar in World War II. Under this type of contract, the contractor receives a fee predetermined before the beginning of the contract, usually based upon a percentage of estimated cost; it is not subject to increase. There is some tendency towards lack of flexibility in the allowance of fixed fees as compared with profit allowances under price-redetermination clauses, and a much greater preoccupation with actual historical costs as a major factor in establishing the reimbursement to the contractor. On the other hand, there are some contractors who much prefer the cost-reimbursement type of contract to any other, because it provides definite assurance of the return of actual costs with the accompanying reduction of risks. It is a more or less general practice of some large industrial corporations, who act as agents by contract for the operation of certain government-owned plants, to use a cost-reimbursement type of contract under which they receive management fees together

with an allowance for all the actual operating costs of the plants.

The Armed Services Procurement Regulations contain a Statement of Contract Cost Principles in Section XV. This statement, however, is applicable only to cost-reimbursement type contracts, including those with nonprofit institutions for research and development work and with construction contractors, as well as supply and research contracts with manufacturing concerns. This statement has been criticized, but it has been generally accepted by industry for the purpose for which it was intended.

However, there has been an unfortunate lack of a statement of contract cost principles applicable to fixed-price contracts, including those containing price-redetermination and incentive clauses. There have been allegations that contracting officers have used cost data supplied by contract auditors for use in negotiation of fixed-price contracts based exactly upon the cost principles stated in Section XV. Possibly this is unavoidable in the absence of complete written cost principles. In any event, the Department of Defense has accepted the need for a statement of contract cost principles with respect to fixed-price contracts, and such a statement is now being prepared. Consideration will be given to a complete revision of Section XV, with the intent, if possible, of establishing one set of contract cost principles applicable to all types of negotiated contracts.

I do not wish here to discuss contract cost principles in detail, but a few observations on this subject may be of interest.

We all subscribe to the principle that equity should prevail in the determination of costs, either estimated or actual, for pricing negotiated contracts. We also recognize there is an occasional contractor who is wasteful and extravagant according to our standards, and we desire by contract to place some limits upon his costs where he is to be reimbursed on the basis of costs under any type of contract. We believe the vast majority of well-run American corporations will agree with this principle, and, they will as taxpayers, desire that the occasional offender

be kept in line and not overstep himself.

Contractors who have had experience with contract cost principles should recognize generally that the judgment of the individual management as to reasonableness of cost items is not often questioned. However, based upon principle, there have been and are frequent relatively picayunish disallowances of small relative significance that offend the sense of equity of contractors and result in criticism far out of proportion to the amounts involved.

We may also state that Section XV of the statement of contract cost principles is too rigid. It draws too sharp a line between those items of cost which are considered to be allowable and those which are considered to be unallowable. It must be recognized that this statement was prepared solely for use with cost-reimbursement type contracts which largely relate to products of a specialized nature for which the government is the sole customer. We recognize that the problems of costing standard commercial products, or items related thereto, for sale through normal commercial channels are different from the problems encountered in pricing products which are the subject of cost-reimbursement-type, prime contracts. In practice, even without a statement of contract cost principles, we believe these differences are generally being recognized in pricing fixed-price contracts.

The foregoing comments all add up to the conclusion that the revised statement of contract cost principles should be more explicit with respect to the circumstances under which various elements of costs are considered to be allowable or unallowable. Reasons for unallowability should be clearly set forth to the public.

In connection with the establishment of a complete statement of contract cost principles, the Department of Defense has conferred and will continue to confer with and receive advice from one of the committees of the American Institute of Accountants as well as committees from various other groups, including nonprofessional trade associations. In this process, you may be assured that the views of accountants and businessmen on the accounting aspects of pricing negotiated

contracts will receive a full airing. We shall also confer with and ask advice of the General Accounting Office on this subject, but we recognize the ultimate responsibility of the Department of Defense to adopt a statement that will be fair to both government and business and be proof against criticism from the public and the Congress, who have a vital interest in these matters.

It should be understood that the contracting agencies of the federal government have the power to make specific agreements with contractors regarding the items which are allowable as contract costs and the methods of allocation of contract costs to products subject to pricing under negotiated contracts. To the extent possible, it is desirable that the contract terms be specific as to cost principles. Only to the extent they are not specific can there be later disagreement between the parties or with representatives of the General Accounting Office in exercising their power to review contract payments.

I would like to close with a brief discussion of two important cost problems presently facing us.

Since World War II, there has gradually grown the practice, in the determination of costs under cost-reimbursement-type contracts, intended to simplify and expedite reimbursements, of a predetermination by negotiation of overhead rates. In practice, it has been found that such negotiations have been time-consuming and expensive, so that there is some question regarding the simplicity of the practice. Moreover, the policy has recently been attacked on the basis that the predetermination of overhead rates has been unfair and unreasonable from the standpoint of the government because (1) in many instances actual overhead rates under revised schedules of production have been less than those established, and (2) that once overhead rates are predetermined with respect to direct labor, there is a positive incentive to contractors to be inefficient in the use of direct labor in the same manner that the former cost-plus-a-percentage-of-cost contract was a positive incentive to contractors to increase their

aggregate costs. It is possible that the use of predetermined overhead rates may be suspended.

I have been asked to comment on the present status of amortization of emergency facilities as an allowable item of contract cost. When consideration was first given to this matter, it was realized that the certificates had been issued for necessary expansion of practically all types of American industry, including businesses whose products' selling prices are limited by price controls, those whose selling prices are subject to regulation, such as railroads and electric light and power companies, and those engaged in the production of military end-items. Therefore, it was well understood that it would be impossible to lay down a single rule applicable to all such kinds of operations.

After many discussions with various agencies of the Government, on 14 August 1951, the Director of Defense Mobilization, Mr. Charles E. Wilson, issued Defense Mobilization Order No. 11 making it permissive, but not mandatory, to allow accelerated amortization as an item of contract cost to the extent that such amortization is based upon excluding the portion of the cost of facilities estimated to be fairly allocable to the post-emergency period. Simultaneously, he suspended the issuance of certificates of necessity for sixty days, with certain exceptions, and asked for a survey by the Defense Production Administration of the practices in issuance of certificates of necessity, including a study in cooperation with the procurement agencies, of certificates previously issued from the standpoint of determining the portion of the cost of the facilities that should be allowable as costs under negotiated contracts. This determination was to be made without intent to revise the amounts certified for tax purposes. On the basis of the survey, procedures were to be established for similar determinations with respect to certificates to be issued in the future.

The methods and the degree of application of these principles have not as yet been definitely determined. However, the Administrator of the Defense Production Administration recently appointed a com-

mittee composed principally of representatives of business for the purpose of making recommendations on this subject. It is hoped that through the efforts of this committee principles will be formulated in implementation of the directive.

It was natural that the question should be raised as to the practicability of making estimates of loss of economic usefulness of emergency facilities applicable to the emergency period. While, in our opinion, such estimates can and should be made, it cannot be denied that they require the exercise of a high degree of judgment. Those who doubt that estimates of loss of economic usefulness can be fairly determined would prefer to allow only normal depreciation on such facilities in contract pricing, leaving contractors to receive any additional recoveries on emergency facilities through tax savings on that portion of the amortization which is in excess of normal depreciation. This theory, in our opinion, is unsound in that it fails to take into consideration the fact that full recovery of loss of economic usefulness can only be effected if amortization of emergency facilities is allowed as an element of cost in contract pricing. Accountants familiar with the subject will be thoroughly in accord with this statement.

Undoubtedly, most contractors who sought and obtained certificates of necessity had an eye on the Renegotiation Act of 1951, as well as the Revenue Act, in making decisions relative to the acquisition of emergency facilities under certificates. The Renegotiation Act of 1951, consistent with the practice in World War II, provided for the allowance of amortization as an element of cost of negotiable business upon the same basis as allowable for tax purposes. However, this provision of the Renegotiation Act may be amended, by the so-called Eberharter Amendment now being considered, to provide a limitation on the allowance of amortization based upon the same standard as provided in Mr. Wilson's directive on initial contract pricing. Such uniformity would be desirable, provided the Wilson directive is actually implemented in initial contract pricing.

JOHN T. KOEHLER, until recently Assistant Secretary of the Navy, is now Chairman of the Renegotiation Board. He joined the Office of the General Council for the Navy Department in 1946, and later became Counsel for the Bureau of Ships as well as Navy Dept. General Counsel

## *Renegotiating Under The 1951 Act*

John T. Koehler, Chairman, Renegotiation Board

I APPEAR BEFORE YOU this afternoon charged with the task of discussing "contract renegotiation." In view of my limited knowledge of the subject, I look upon this task with a considerable amount of controlled enthusiasm and can only hope that, after I have finished, you will not charge me with having accepted your hospitality under false pretenses.

I moved into my present job on Wednesday last from the Navy Department where, for the past two and a half years, I have been Assistant Secretary in charge of all procurement and production programs. In this assignment, I have had ample opportunity to deal directly with industry and I learned to appreciate the part industry has played, and must continue to play, in the defense of the nation.

We Americans are indeed fortunate that our tremendous industrial power permits us to produce great quantities of highly complicated and scientific equipment and that it permits us to provide our servicemen with the finest equipment in the world and to make up in firepower, what we lack in manpower.

It is hardly necessary to remind you that our industrial power depends, for its very existence, on a strong, vigorous, and healthy national economy and that that economy depends, in part, upon a careful husbanding of our national resources. Ever since June 1950, our governmental expenditures for military purposes have been increasing at a rapid rate. For the fiscal

year ended June 30, 1951, the total Department of Defense obligations exceeded 49 billion dollars of which 35.3 billion dollars covered procurement obligations for major equipment, supplies, military construction, and expansion of production facilities. For the fiscal year ending June 30, 1952, these defense obligations, including military construction, will exceed 60 billion dollars and military orders are currently being placed at a rate in excess of one billion dollars a week.

To add to the magnitude of our task, this rapidly expanding defense production program is not, and cannot be, evenly distributed throughout the country. It is most highly concentrated in aircraft, combat vehicles, electronic equipment, some vessel construction, new weapons such as guided missiles, and other items the prime contracts for which must go to contractors located, in the main, in areas of industrial concentration. By subcontracting and other means, we must do what we can to minimize this concentration. We must guard against creating new facilities in cases where existing facilities are able to carry the load; we must assure a sufficient supply of machine tools, production facilities, and critical materials to our manufacturers if the production rate of end items is to be maintained at a pace consistent with security requirements. Finally, but by no means least important, we must do what we can to assure small business a fair percentage of military procurement in

order that we may have as broad an industrial base as possible.

Up to this point, I have been speaking more as a government official charged with procurement responsibilities than as a Member of the Renegotiation Board. However, I hope you will agree with me that, if confined to its proper sphere, renegotiation can and should play an important part in government procurement of military materiel during war and during periods of preparedness such as face us now. In its statement of policy in the Renegotiation Act of 1951, Congress declared that the sound execution of the National Defense Program requires the elimination of excessive profits made from contracts made with the United States and from related subcontracts and that such excessive profits be eliminated in accordance with the provisions of the Act.

I shall not take up your time with a consideration of previous renegotiation legislation since I am sure that all of you are thoroughly familiar with it. I believe that I can summarize our past experience in renegotiation by saying that, by and large, an experiment which began in 1942 thoroughly proved its worth during the years of World War II. It has been estimated that determinations of excessive profits amounting to over eleven billion dollars were made during the effective period of the 1942 Act. In addition to these direct savings, renegotiation exercised a substantial influence, which cannot be calculated in dollars, in bringing about lower prices for Armed Services procurement while civilian prices were slowly rising.

One of the distinguishing features of renegotiation is that each individual contractor is renegotiated on the basis of the merits of his own particular case. There is no fixed base for classes or types of industry or for industry in general, but the same uniform standard factors are applied to each of the individual cases. In this connection, I would like to call your attention to the following statement which appeared in the Military Renegotiation Regulations for the 1948 Act:

"In general, reasonable profits should be determined by over-all evaluation of the particular factors present without limita-

tion or restriction by any fixed formula with respect to rate of profit, or otherwise. Renegotiation proceedings should not result in a profit based on the principle of a percentage of cost. Contractors who sell at lower prices and produce at lower costs through good management, improved methods of production, close control of expenditures, and careful purchasing will receive a more favorable determination than those who do not. Such favorable or unfavorable determination will be reflected in the profits allowed to be retained by the contractor or subcontractor as nonexcessive. Claims of a contractor for favorable consideration must be supported by established facts, analyses, and appropriate comparisons."

I now come to a consideration of the 1951 Act and I hope you will forgive me if I confine my remarks to a resumé of statutory provisions and do not venture into the realm of predicting broad policy. I might add, in passing, that the ink was hardly dry on our commissions before advice began rolling in but, to date, the only official action the Board has taken is to grant an extension of time to March 1, 1952 for filing the financial statements required by Section 105(e) (1) of the Act to all persons having fiscal years ending prior to November 30, 1951.

But to return to the Act, the Renegotiation Act of 1951 was approved on March 23, 1951 and provides for the renegotiation of certain contracts made with the United States in the course of the execution of the national defense program in order to eliminate excessive profits. The principal provisions are summarized as follows:

The Renegotiation Board is established as an independent executive establishment consisting of five members appointed by the President and confirmed by the Senate. The principal office of the Board must be in the District of Columbia. For the first time, therefore, we have a Board which is wholly independent of those agencies of government charged with contract negotiation. I speak for all members of the Board when I say we fully recognize the importance of this provision. It has often been said that "renegotiation is the opposite

side of the coin of negotiation." I cannot accept that statement. It is true that there must be close liaison between procurement personnel and renegotiation personnel but that both groups should report to a common superior who has procurement responsibilities is, in my opinion, an unsound concept. Congress has taken the same view for, should the Board decide to delegate any of its authority, such delegation may not be to any person engaged in procurement or in the supervision of procurement.

The Act applies to: (1) receipts and accruals on or after January 1, 1951 from contracts and related subcontracts with the military departments, the Department of Commerce, the General Services Administration, the Atomic Energy Commission, the Reconstruction Finance Corporation, the Canal Zone Government, the Panama Canal Company, and the Housing and Home Finance Agency, and (2) to receipts and accruals from contracts and related subcontracts with such other agencies performing defense functions as the President may designate. The Act does not apply, however, to receipts and accruals attributable to performance prior to July 1, 1950 under contracts and subcontracts which were not subject to the Renegotiation Act of 1948. (By an Executive Order dated June 27, 1951 the President designated the following additional "Departments": The Federal Civil Defense Administration, the National Advisory Committee for Aeronautics, the Tennessee Valley Authority, and the United States Coast Guard. The provisions of the Act are applicable to all contracts with each of these agencies named in the Order and to related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor on or after the first day of July, 1951.)

Contracts which the Board determines do not have a direct and immediate connection with the national defense are mandatorily exempt and the Board's regulations and determinations in this regard shall not be subject to review or redetermination by any court or other agency. The Act applies to all contracts falling within its terms, and such contracts shall

contain stipulations consenting to the elimination of excessive profits through renegotiation. It does not apply to receipts and accruals attributable to performance after December 31, 1953; nor to certain types of contracts specifically exempted from the Act, or granted exemption by the Board, which exemptions may be granted both individually and by general classes or types.

A contractor or subcontractor having less than \$250,000, and certain subcontractors such as brokers or sales representatives having less than \$25,000, of yearly renegotiable business shall not be renegotiated under the Act. If the noted amounts are exceeded, the amount of profits that may be eliminated under renegotiation cannot be greater than the amount of such excess. In computing the aggregate of receipts and accruals of contractors under common control, intercompany sales shall be eliminated.

Every holder of contracts or subcontracts subject to the Act shall file with the Board, on or before the beginning of the fourth calendar month following the end of the contractor's fiscal year, a financial statement in such form as the Board shall, by regulation, prescribe. In addition, the contractor must furnish such other information, records and/or data as may be determined by the Board to be necessary. A penalty of \$10,000 and/or one year's imprisonment is provided for wilful misrepresentation or failure to comply. The Board also shall have the power to audit the books and records of subject contractors and subcontractors.

In determining excessive profits, the Board must give favorable recognition to the efficiency of the contractor, and in addition must consider the following factors: reasonableness of costs and profits (with particular regard to volume of production and comparison of war and peacetime products), the net worth (with particular regard to the amount and source of public and private capital employed), contribution to the defense effort, the extent of risk assumed, the character of the business, and such other factors (to be published by the Board) as public interest and fair dealing may require. All allowable

Federal income tax deductions and exclusions shall, to the extent allocable, be allowed as items of cost, including any excess of costs paid or incurred in the preceding fiscal year over the amount of receipts or accruals subject to the Act which were received or accrued in such preceding fiscal year, but only to the extent that such excess is not attributable to the gross inefficiency of the contractor. No loss so incurred in any fiscal year ending prior to January 1, 1951, may be carried forward.

Renegotiation proceedings will be commenced by the mailing of notice to that effect to the contractor by registered mail. The Board will endeavor to make an agreement with the contractor with respect to the elimination of excessive profits. If no such agreement is reached, the Board shall issue an order determining the amount, if any, of excessive profits, notify the contractor thereof and, if the contractor requests it, furnish a statement of the facts used as a basis for the determination and its reasons therefor. Determinations shall be based on the aggregate of receipts and accruals during the fiscal year or other agreed period under contracts held by the contractors, except that contracts may be treated separately on request.

By agreement with any contractor, the Board may in its discretion conduct renegotiation of two or more related contractors on a consolidated basis. Renegotiation must be conducted on a consolidated basis with a parent and its subsidiary corporation if all the corporations included in such affiliated groups request renegotiation on such basis and consent to such regulations as the Board shall prescribe, including regulations for determining the amount of excessive profits allocable, for tax credit purposes, to each corporation of the affiliated group.

After an agreement or order for the elimination of excessive profits is made, the Board shall direct the appropriate agency head to eliminate the excessive profits by reductions in amounts payable under contracts otherwise due the contractors; or by directing Government contractors, and subcontractors thereunder, to withhold amounts due to any contractor or subcon-

tractor having excessive profits to be eliminated by suit; or by any combination of such methods. The Board has the power to extend the time for payment of sums due under an agreement or order. Protection is provided for assignees of subject contracts against withholding for renegotiation liability of the assignors by limiting such action to the extent provided in the Assignment of Claims Act of 1940 as now or hereafter amended. Banks and other financing institutions to which any subcontracts are assigned are also protected against withholding or recovery.

The Act provides for a period of limitation—the contractor is discharged from all liabilities for excessive profits for a given fiscal year if renegotiation proceedings are not commenced within one year after the filing of the financial statement required to be filed with respect to such fiscal year; or if an agreement or order is not made within two years following the commencement of the renegotiation proceeding. To this there are two exceptions: the two-year period may be extended by mutual agreement and it does not apply to review of an order by the Board if the order is made within the two-year period.

Within ninety days a petition may be filed in the Tax Court for a redetermination of excessive profits determined by the Board. This is a proceeding *de novo* to redetermine excessive profits, if any. The filing of such a petition shall stay the execution of the order, if the petitioner post sufficient bond within ten days. With certain limitations, interest on excessive profits shall accrue at the rate of four percent from the 30th day after the order of the Board or from the date fixed in an agreement for repayment. Interest at the same rate shall accrue in favor of the contractor on any amounts required to be refunded after redetermination by the Tax Court.

I believe that the foregoing will give you a broad overall picture of the present law. I have purposely omitted from this summary any discussion of technical changes in the World War II Act made to coordinate it with the provisions of the 1951 Act. I have similarly omitted any discussion of the manner in which the transi-

tion is to be made from the 1948 Act to the 1951 Act. I do not anticipate any substantial difficulty in this transition.

In conclusion, I should like you to consider, if you will, one final fact which is all too often overlooked or bypassed by many of those who are not charged with the grave responsibility of carrying out a national program, whether it be in the field of rearmament, economic stabilization, renegotiation, or in one of the many areas which have as their common goal the welfare and security of our people. If these programs are to succeed, their success depends, in large measure, upon affirmative answers to three questions, namely:

1. Is there a need for the program?
2. Is the plan for carrying it out a sound one? and
3. Can competent personnel be secured to do the job?

I am convinced that there is a real need for renegotiation in times like these and that the 1951 Act answers that need with sound legislation. I am also convinced that

the Renegotiation Board will be unable to do an effective job unless it can secure the services of competent and objective people both in and out of government to ensure proper organization, effective implementation and fair and impartial results. It follows, as it always does, that the answer ultimately lies in the capabilities and objectivity of the people who are called upon to do the job. I would like you to remember this fact when, in the near future, I call upon representatives of your profession to drop their civilian pursuits for the time being in order to help us discharge our responsibilities.

Each of us in these perilous times must bear his fair share of the added burdens which international tensions have placed upon us. As you and I place upon our shoulders our fair share of the load, we can hold our heads high and close ranks with our fellow men, whether in or out of uniform, in our mutual defense of our beloved country.



ROY BLOUGH is a member of President Truman's Council of Economic Advisers. Previously he held such posts as: Assistant to the Secretary of the Treasury, Director of Tax Research in the Treasury Department, professor of economics and political science at the U. of Chicago. He was editor of the National Tax Journal

## *Economic Problems of Mobilization*

Roy Blough, Member, Council of Economic Advisors

AS ACCOUNTANTS in close touch with the operations of particular businesses, you are keenly aware of the problems that mobilization has brought and is bringing to them. Some of these problems, such as those involved in 5-year amortization, renegotiation, the excess-profits tax and price adjustments under price regulation orders, directly raise accounting problems. Others are more general problems of business management. In the mobilization period both the importance and difficulties of anticipating future developments with respect to such matters as availability of materials, the desirability of expansion, probable defense contracts and the course of demand and prices are multiplied.

Broadly considered, the economic problems of mobilization of the nation as a whole consist of the sum total of the economic problems of all the different consumers, businesses, workers, farmers, investors, pensioners, etc. This does not imply, however, that if every individual and every business seeks to solve his own problems that it will all add up to a solution of the problems of the economy as a whole. For example, particular businesses may aggravate the national economic problem of scarce materials by successful efforts to accumulate and hoard them, while individuals and groups may aggravate the rise in prices by successful efforts to protect themselves against such a rise.

Accordingly, in the mobilization period,

it is necessary to have collective action to restrain individuals and businesses from doing some of the things that come naturally. Collective action means that the individual is subjected to more or less restraint by his fellows; it is government of one kind or another. Some of our government is carried on through organizations that are essentially private in character. Your own American Institute of Accountants is an example of such an organization. It performs functions of a governmental character with respect both to examinations for certification and to the setting of standards for accounting procedures.

Many kinds of restraints, however, cannot safely be entrusted to private forms of collective action. The particular group may have interests that, if they were served, would be detrimental to the interest of the rest of the public. In general, if we must be governed, we want to be governed by people who, in the final analysis, derive their power from the whole public and not by particular groups.

Successful government has two aspects. One is the intelligent design and execution of measures and policies appropriate to solve the problems giving rise to governmental action. The other is the understanding and support of a large majority of the population. Democratic governments can force rules down the throats of only a small recalcitrant minority.

Why not rely on automatic market forces

to achieve the economic goals of mobilization? Why does partial mobilization require an enlargement of governmental economic programs? Do not these programs reflect the "grasping of power-hungry bureaucracies"? To answer the last question first, if I can trust my own observation, virtually no one in government likes controls. It does not stand to reason that businessmen of high prestige who go to Washington suddenly develop a fondness for controls that they formerly detested. Operating controls is a terrific nuisance for the Government and may boomerang politically at any time. Controls are adopted only when they clearly appear to be needed; they are imposed reluctantly, and for that reason sometimes belatedly.

The reason why automatic market forces are inadequate to achieve the economic goals of mobilization, thereby necessitating special governmental economic programs, is that the jolt of mobilization is too great for market forces to absorb. The result of the unassisted operation of these forces might well be a market chaos that would not only destroy economic stability, but seriously impair defense production as well.

The economic problems of mobilization that will not solve themselves without governmental action are of two kinds. The more basic one is the problem of securing an adequate volume and speed of defense production. The other problem which derives from the first is that of maintaining a stable economy, particularly a stable price level during the period of build-up in defense production . . .

The production problem of defense mobilization is to increase production of needed defense material and supporting productive capacity as rapidly as possible up to the levels required. To achieve this increase requires the devotion of resources—both physical resources and human resources—to kinds of production that will have top importance in promoting the military security of the nation. This mobilization of production is partly a matter of increasing total production through the more effective use of resources that have been idle or not effectively employed. Mobilization also requires that resources

be diverted from less important to more important kinds of production and particularly from production of civilian goods to production of military equipment and supplies. Big shifts must be made and made quickly. Making these production shifts creates another major economic problem, that of maintaining a stable economy. The more successful the effort speedily to enlarge necessary defense production the more intense the stabilization problems are likely to be. The drastic rechanneling of production introduces strains and distortions into the economy. Some persons find themselves luckily better off than they ever were before. Some, through no fault of their own, may suffer temporary unemployment, or business loss, or be obliged to change jobs and move their families to strange surroundings.

The most universal and most dangerous type of economic instability that is likely to result from the rechanneling of production is of course that spreading rise of prices which we call inflation.

The problem of inflation arises primarily because demand runs ahead of supply. Government is spending more and taking more of the total product, which leaves a smaller fraction for consumers and private business. But consumers in the aggregate seek to spend more because a larger number of persons are working longer hours at generally higher wages and so have more income. Businesses seek to expand their plants and equipment and to build up inventories in order to do more business and make more profit. These buying pressures are accentuated when persons and businesses spend their accumulated savings or borrowed funds. With spending thus tending to outrun supplies, inflation results unless measures are taken to prevent it.

These, then, in brief are the two major economic problems of mobilization. What are the programs by which the government is endeavoring to solve them?

The first and most basic program for securing the required expansion of defense production is the procurement program, including the planning and scheduling of production. Congress appropriates the funds and authorizes contracts for

goods and services need to clothe, feed, train, and equip the armed forces with adequate supplies of modern weapons, and to build a productive machine capable of a greatly expanded production of weapons, if required by all-out war. The military planners draw the specifications and the procurement officers let the contracts. The production is carried on by private industry.

Ordering the goods is not all that is required to assure their prompt production. Supplies of many materials and facilities, especially metals and machine tools, are insufficient to fill all demands. To protect the procurement program from being halted or delayed by the competing demands of consumers and businesses, it has proved necessary to adopt priority and allocation programs. Defense production and essential civilian production are given the green light, but many other projects must be postponed. Making sound decisions regarding essentiality is both an important and a difficult task. Not only profits and employment are at stake, but more important, the national welfare, productive strength, and military safety.

Several measures are used to give positive encouragement to business to expand needed productive facilities. In some cases, long-term purchase contracts are granted to reduce risks of loss from plant expansion. The privilege of depreciating property for tax purposes over a 5-year period instead of over the longer periods which would otherwise be necessary had been granted for many new facilities. Loan programs provide Federal funds for important projects when private financing is not available. In some cases, subsidies have been used to get an expansion of mineral production that might not take place at market prices. A voluntary manpower program encourages training, bringing new persons into the labor market, and placing them in jobs where they will be most useful workers.

I turn now to the stabilization programs which relate largely to the prevention or mitigation of inflationary price increases of all kinds—raw material prices, wholesale prices, retail prices, wages, salaries, rents, and so on. Prices are very sensitive

to the production shifts of the defense program and might become chaotic in the absence of stabilization programs. One man's price is another man's cost. Price rises in any important economic sector are likely to give rise to price rises elsewhere, and so on around, which is the inflationary spiral.

Prices are determined in large measure by the relation between supply and demand. Price stabilization measures accordingly seek to restrain demand while at the same time increasing supply. The increase in supply by increased production helps furnish the goods which consumers and businesses desire. The more of a person's wants that are satisfied, the more willing he is likely to be to accept a reduction in the remainder of his expenditures. However, defense production cannot cure the inflation problem, because the added production is reflected in larger incomes which consumers and businesses have to spend and thus increases demand.

The first and most basic stabilization program is taxation. During mobilization, more resources must be used by government; that means that the public must use less resources. The government commands the resources by spending, so the public must spend less. Taxes pay for the government spending and cut down the spending of business and consumers. Truly adequate taxes in a mobilization period would reduce private demand sufficient to offset increases in government demand. This would require at least a balanced budget and probably a large surplus.

This emphasis on taxation is not intended to imply that tax increases alone could be counted on to maintain economic stability and prevent price rises during the mobilization period. The record of July 1950 to March 1951 showed clearly that in anticipation of the defense program large spurts of consumer and business buying as well as substantial price increases may take place even when the government's budget is fully in balance or shows a surplus. A balanced budget or preferably a surplus is, however, a foundation measure needed to support all stabilization programs.

Unfortunately that foundation is proving

very difficult to secure. The tax increases that are about to pass Congress likely will not prevent substantial deficit in the fiscal year 1952 and, unless heavily supplemented by later tax legislation, a large deficit in the fiscal year 1953. We are told that this tax bill scrapes the bottom of the tax barrel, and indeed that it has taken the bottom itself. These remarks undoubtedly refer to the political bottom of the barrel rather than the economic bottom. Fortunately, the political bottom, or the political ceiling, to use another figure, changes location from time to time. If the past is repeated in the future, when the public sees the need it will support substantial further tax increases.

Several arguments against higher taxation have common currency. One argument is that taxes should not be increased until unnecessary governmental spending has been eliminated. Reducing governmental expenditures would of course help to ease both the production and the stabilization problems. The reductions that already have been made in nondefense expenditures are substantial, especially if increasing costs are taken into account.

It is fully within the power of Congress to reduce expenditures still more if it chooses to do so. The rub comes in defining "unnecessary." Substantial reduction in governmental spending can be achieved only through reducing the programs of services rendered. Critics who put their emphasis on cutting personnel are attacking not the roots of the problem but only the leaves. Personnel cannot be greatly reduced if the programs are to be carried into effect, and even large personnel cuts would affect only a small part of total governmental expenditures. Virtually every Federal spending program has the strong organized support of groups of citizens who consider that program to be essential. To be sure, each group sees other programs that it thinks should be reduced, but these also have their defenders. When the smoke clears away the amount of "unnecessary" expenditures lopped off is likely to be disappointingly small.

It is not safe either to count on or to wait for expenditure cuts to solve any part of the stabilization problem. If after

adequate tax increases are provided, substantial expenditure reductions are actually realized and result in a budget surplus, which is a most unlikely result, that surplus will be highly desirable. Any tax reductions that proved to be possible at that time surely would not be resented by taxpayers.

Another argument against higher taxes is that they will damage the economy. Some of the same persons said the same thing in 1929 and in 1939 and no doubt in other years before, between, and after these. Since those dates, taxes have greatly increased. The economy has also grown to such an extent that most persons have much more real income after taxes now than they did then. Capital investment, business profits after taxes, and the level of living have all risen in real terms, after adjusting for price changes. These facts do not of course prove the falsity of claims that further tax increases would damage the economy, but they cast a good deal of doubt on the reliability of such claims.

The relation of taxes to the economic burden of the defense program is often misunderstood. That economic burden consists of the goods that we must do without because resources must be used for defense production rather than to produce civilian supplies. Holding taxes down during the mobilization period will not make any larger the supplies of goods and services which the public as a whole can purchase, and increasing taxes, if carefully done, will not reduce the supplies. Tax increases do not increase the economic burden of the defense program; they distribute it much more fairly than does inflation. There seems to be no question that the economic burden of the present program can be borne, which is at least *prima facie* evidence that the tax burden to pay for it also can be borne.

A tax increase might be said to have exceeded the economic limit if it had no anti-inflationary effects. There is a simple misunderstanding on this point that ought to be cleared up. It is often said that tax increases will not be anti-inflationary because the money will be spent by government. The only case in which the argument is valid is one in which the

money would not be spent by the government unless the tax was levied. During the mobilization period, however, expenditures will likely be made in the amounts that are deemed necessary for national security, with little if any regard for the volume of taxes. Effects of expenditures and effects of taxes are thus separate and independent. The increasing of taxes would thus reduce inflationary pressures by decreasing spendable funds in the hands of the public.

For a tax increase not to be anti-inflationary, one of three results would have to follow its imposition. The tax rates might be so high that incentives to work and produce would be seriously reduced, resulting in the supply of goods being reduced as much as or more than the demand was reduced by the increased tax. Or, the tax increase might put taxes so high that the taxpayers would be outraged and would literally force an increase in their compensation regardless of controls imposed to prevent it. Since controls and taxes alike must fail unless there is general acceptance and cooperation by the public, the whole stabilization program might be threatened. Or, the tax increases might so stimulate efforts to evade and avoid payment that the collections would not increase.

The political ceiling to taxation is likely to be so far below the economic ceiling that we scarcely need worry about raising the general level of taxes too high for the economy to carry. Tax increases of course should not be permitted to be offset by compensatory price or income increases of the persons or businesses on which the tax burden was intended to fall. Moreover, we should be on the lookout for signs that specific tax rates are being put too high, since this might happen when the general level of taxes was still well below the economic limit.

An important obstacle to adequate taxation is that each of various economic groups believes that the tax burdens can and should be pushed off on to other groups. The resulting struggle takes the form of resistance to specific tax increases, and this in the aggregate is resistance to tax increases generally.

It is unfortunate that the fight against inflation is weakened by the seeming unwillingness of Congress, after its splendid start in 1950, to provide adequate tax revenues in 1951. The result is to make more difficult the task of other stabilization programs. These programs must bear a greater load and have less chance of success when taxation is not adequate to the need.

A second program for stabilization is the increase of personal and business savings. Saving is the nonspending of income; and nonspending does not create inflationary pressures. To be effective against inflation, savings must not be used to purchase such investments as housing, or inventories, or new capital equipment. Such uses of saving increase demand just as spending on consumer goods. To be most effective against inflation, the savings should either be held in cash or used to buy Government securities. If other kinds of securities are purchased or if debts are repaid, the persons to whom the money is paid must, in turn, either hold the funds in cash or purchase government securities, if the anti-inflationary effect of saving is to be achieved. Money held in cash has the disadvantage that it seems to burn holes in some people's pockets, so that the saving may not be as permanent as if the savings are held in some other form. Buying government securities is a particularly good way of holding savings because the government can use the funds to keep down its debts to banks, thereby restricting the volume of money. The Savings Bond campaign now under way should be vigorously supported. Every effort should be made to expand the amount of savings done by the public in this period of mobilization.

Several factors enter into the size of personal savings. If you do not expect prices will rise, you are likely to postpone more spending and thus save more than if you expect prices will rise. If you expect goods will become scarce in the future, you will likely save less now than if you expect a plentiful supply. Accordingly, the degree of inflationary pressure that is expected is in itself a force affecting the rate of saving, which in turn

affects inflationary pressure. Shortages of such goods as durable consumers' goods, such as automobiles, washing machines, refrigerators, and the like, if combined with vigorous price control measures, may in the months ahead create substantial amounts of personal savings, since many people would rather save their money to be able to buy these goods in the future than to use their whole incomes in buying other kinds of goods.

Although very helpful, savings are not as good an anti-inflationary measure as are taxes, because adding to government debt increases the cost of debt service and may lead to future inflationary dangers.

Borrowing money to use in buying goods is the reverse of saving; it has the effects of negative saving. Therefore, to maintain the maximum amount of net personal and business saving, it is necessary to hold down borrowing. The restriction of borrowing is the purpose of several of the government's anti-inflationary programs. Selective credit controls are used to cut down the amount of borrowing to buy durable consumers' goods and new houses. Recently the Congress has seen fit to weaken the application of these restraints. A voluntary program of credit control and certain other measures have been employed to restrain the general expansion of credit.

Still another program for stabilization is that of direct controls of commodity prices, wages, rents, etc. One of two mistakes is commonly made in considering price and wage controls.

On the one hand, it is a mistake to expect too much from them. Some people have assumed that the whole job of stabilization can be done simply by fixing prices and wages. This view leaves out of account the effects of the mobilization program on the demand for and supply of goods. Without being firmly backed up by tax, credit, and savings programs, price controls will lead, if effective, to empty shelves and, if ineffective, to black markets. Other stabilization programs to reduce demand are important to make price controls effective. Price controls need to be effective if wage controls are to be effective since otherwise the major burden

of mobilization would be concentrated on the wage-earning groups.

On the other hand, it is a mistake to say that price and wage controls can do no good at all, or that they necessarily do more harm than good. Price and wage controls can, in fact, make a major contribution to stabilization by restricting the increase of incomes, and, by the same token, restricting increases of costs. The inflationary spiral is produced by two forces: increased spending power, which pushes prices up by raising demand, and increased costs, which make it necessary for sellers to raise their prices. An increase in one price leads to other price rises throughout the economy, and prices and wages are similarly interlocked. Price controls and wage controls help to hold down both incomes and costs, and thus help to cut off the inflationary spiral.

Thus far I have described how the economic problems of mobilization are being met through a comprehensive set of programs directed toward achieving production goals and maintaining a stable economy. Many of these programs, such as the procurement, taxation, credit, and savings programs, are entirely consistent with the economic freedoms of more normal times—freedoms which are a keystone of our national policy and a foundation for our national prosperity. Other programs such as materials controls, price controls, and wage controls, inevitably impair economic freedom and would not be used if the situation did not require it. If continued over a long period, such controls could have serious effects on the economy. But not using them during the intense period of defense mobilization would cause even more damage.

The success of the production programs seems to be assured in the sense that the economy clearly can and will produce what is required under the present defense program. The success of the production programs will always be relative, however, since it is not likely that we shall produce enough or produce it soon enough to meet desirable goals.

The realization of the defense production programs will inevitably be at the expense of other important segments of

the economy. The production of consumers' durable goods is being cut back. Structural steel is in short supply, with the result that commercial and other construction are being sharply restricted. There are other crucial shortages. Many state and local improvement projects will probably have to be postponed. The allocation of scarce materials and other scarce resources certainly will never be solved to the general satisfaction of the public.

Many projects of seemingly high priority will have to be set aside until later. It is simply impossible to take care of them all. The problem is to see that the cutbacks are intelligently made with a broad view of the national interest in the present emergency.

How successful the stabilization program will be depends on many factors, some economic, some political. The relaxation of inflationary pressures and the resulting downward drift of many prices over the past few months is very encouraging. But the growing defense expenditure will be a powerful influence toward producing a new period of strong inflationary pressure. There is no basic reason, however, why the anti-inflation programs cannot be put in position to meet the pressure successfully, if and when it comes.

Success in these programs, however, requires understanding support throughout the country. In many respects this support has been gratifying. Unfortunately, however, thus far there is not much evidence that the major economic groups are prepared to accept the sacrifices which successful stabilization requires — sacrifices to be made with or without stabilization.

Stabilization means giving up increases in income which we might otherwise receive. It is not difficult to find people who say they will give up increases in income if they can be assured that their costs will not go up, but usually they insist that all cost increases falling upon them must be allowed to be promptly reflected in higher incomes to them. That is the doctrine of escalation, which prevails in agricultural

prices that are not above parity, in industrial and mercantile prices under the recent revision of the Defense Production Act, and in wage stabilization policy. Insistence on escalation is a very understandable point of view. But if, when controls are first imposed, there is a lack of equilibrium among various prices and costs, and if taxes, savings, and credit controls are not sufficient to hold down demand, how can we expect that prices and wages will be fully stabilized under the escalation principle? Delays in applying escalation would be very helpful in holding increases to a slow rate, as would other methods of absorbing part of the cost increases instead of passing them all along in price and wage increases.

The task of stabilization may be greatly eased if the consuming public voluntarily decides to save a larger per cent of its income than has been in the case in the past, and if business reduces its plans for the expansion of plant and equipment of the less necessary types. However, it is not safe to assume that relief will come from these sources. The experience of the past 15 months indicates how easily a mass movement can develop in an inflationary direction. This is the time to keep our stabilization machinery in absolutely first-class running order with all the necessary powers intact.

We need not look forward to an indefinite continuation of control programs. They are most necessary during the period when the direction of production must be changed and before the normal growth of production has caught up with the additional strain placed upon the economy by the defense program. With a defense program of the size planned, the economy should gradually become adjusted to the new situation, assuming that adequate taxes and other general restraints on demand are imposed. Then the direct controls could be reduced or eliminated. But that is a matter for the future. The problem now is how to make the controls more effective, not how to relax them.

At 31 HAROLD STASSEN was elected Governor of the State of Minnesota. In the middle of his third term as Governor he left to join the U.S. Navy, serving under Admiral Halsey. In 1945 he was appointed delegate to the San Francisco conference of the U.N. He now is head of the University of Pennsylvania

## *Freedom and Finance*

Harold E. Stassen, President, University of Pennsylvania

IN SPEAKING OF FREEDOM AND FINANCE, I should like first to place them in a somewhat broad context. At this moment there is very vivid in my mind an occurrence that happened two month ago in Berlin when I visited that war-shattered center of the cold war. It was the day on which was conducted the parade of one million boys and girls all living under Communist rule. That day I personally observed thousands of these youths slip across the line and come over to the American, to the free section of Berlin. I observed their search for information. I observed the eager manner in which they said, "We are told this and we are told that. Now what is the real truth about it?"

I observed a good many hundreds of them as they gathered in the radio station studio of RIAS, or "Radio Free Berlin," and how there the German commentators and radio announcers of the free Berlin station would answer their questions and give them the information they sought, and how these youths from communist-controlled Eastern Germany would raise these many questions about what they were being told, and about what was happening in the rest of the world, and even about what was happening to them inside the Iron Curtain.

In the midst of one of these sessions, a young lad from Saxony arose, and as he made certain points and asked certain questions, suddenly he said in his own tongue, "Freedom is so precious. *Freedom is so precious.*"

I can report to you from around the world that there is a rising awareness by people everywhere that freedom is precious, that it means so much in the happiness and the enjoyment and the fruitfulness of life.

But one of the things I am most concerned about is that there is not as keen an awareness and understanding of the essential requirements for freedom. Freedom is precious. People are becoming aware of it; aware of it from the reports of those who slip out from under the Iron Curtain; aware of it from the reports of people who dash across the line, like the recent dramatic escape of the Czechoslovakian engineer who drove his train right past the Communist border guards and made it to freedom in the American zone of Germany. They know that freedom is precious from reports like that of the Polish sailors who recently mutinied in the Baltic Sea and got to Sweden and to freedom. They know it from their observations of the whole wide range of semi-regimented or nationally controlled states on up to the reports that now come with increasing frequency and corroboration from the Soviet territory itself.

But frankly my great concern is that people today do not recognize clearly the essential requirements of freedom, of a freedom that will endure, a freedom that children can enjoy and carry on, and pass on to their children. That is the kind of freedom that I would discuss—especially since I know full well the importance of



your leadership in business and the world of active affairs here in our America, which is now the leading nation of the world, populated by only one-sixteenth of the world's people, but producing one-third of all the world's goods and services.

The important point to remember with respect to freedom is that freedom cannot long be maintained unless it is true and complete freedom. By that I mean economic freedom as well as social and political and religious freedom—freedom to buy and to sell, freedom to produce and to manufacture, freedom to invest and to save, freedom to work and to earn.

The economic freedoms, as has been proved over and over again in the whole sweep of history, are inseparable and indivisible from any lasting, true freedom for a people.

I speak of these things now very positively, but not with any partisan spirit or purpose. Rather my concern and my remarks today are beyond party considerations, because actually in these fundamental things, the country's direction, the country's long-term actions cannot be decided by any one political party. Only if the whole of the people understand the essentials and hold firm to them, and in so doing cause them to be embodied in the policies of both parties, only under those circumstances can the basic essentials of freedom and democracy be maintained and kept alive and vital through, not just years, but through decades and generations.

If you pause to reflect on the early history of our country and the great principles of freedom which the Founding Fathers set forth, you will know that those principles have been maintained and have been held through a century and a half or more because they became the very fabric of America and thus were translated into the platforms and policies of all the leading political parties.

So it is with this sense of our nation's history that I now speak about the basic fact of economic freedom—that it is indivisible from a total, true, and lasting freedom in America. It is with this sense that I speak specifically and directly to you about freedom and finance.

It is my conviction that we have been

evolving in America what I would describe as a modern, dynamic, people's capitalism, and that this people's capitalism is something very different from a nationalized economy or socialized state, and also very different from the laissez-faire capitalism of a time gone by. This modern people's capitalism is a dynamic economy. It evolves. And it does so because it recognizes the strength and the rights of labor, and the need for the breaking up of monopolies and for a wide diffusion of shareholding in capital structure. These and many other distinctions characterize the American business and financial scene and make it different from the early systems of capitalism abroad. These distinctive characteristics point to the continuation of a favorable evolution of a modern, dynamic, people's capitalism here in America. Nevertheless, our progress can be halted. We can slip all too easily into the tragic economic mistakes that have wrecked other systems.

Two of these dangers and the means of avoiding them are of very special and direct concern to you. They are matters in which your counsel, your advice, your participation, and your efforts at shaping public opinion are of very great moment. Others I shall touch upon are also of concern to you, but they are more directly the concern of other groups in the national life of our America. In any case, none are more important to any of us than the two that I lay before you—the avoidance of inflation and the maintenance of adequate private reserves of capital for American enterprise. The successful solution of these two problems is essential for the continuance of true freedom in our nation and for the favorable evolution of our economic system.

As to the first problem, it is tremendously important for the long-term economic freedom of a people that its currency, its money, its media of exchange, shall remain sound and shall inspire confidence, that its value shall not be dissipated by a continuous inflationary development. If any economic system reaches a point at which the people do not have confidence that the insurance policies they have taken out will at a future time buy their families an

amount of goods and services that bears a reasonable relationship to what currently can be obtained for the funds invested in those policies, interest in that form of saving will disappear and the life and strength of the economic system will be seriously undermined.

If the people lose interest in savings, which become a part of the capital formation of a country, if they lose confidence in the future value of the dollar units of their savings, if they are fearful of the future purchasing power of their savings, then you have begun to undermine very seriously the economy of your country and, indeed, have weakened the entire social fabric.

And that is why I say to you that this whole problem of inflation, the whole problem of analyzing it, or, to be more specific, of meeting defense needs and other related needs and yet of keeping the country on a sound financial basis, is at the very forefront of the problem of insuring lasting freedom for our people.

When is the point reached at which you have too greatly dissipated the value of the dollar, have too greatly depreciated the currency? When is the point reached at which you have carried inflation too far?

I do not believe any economist or financier can put his finger on such a point. Too many factors are involved—the psychology of the people, the relationship of currency to productivity, and many others equally complex. The tragic experiences of other countries that have gone over the brink and have seen their currency go to pieces do not provide any exact rules for determining the danger point in advance. In inflation you do not know you have gone too far until too late. You discover where you are after you have slid over the edge.

Now economists may argue about when you have gone too far in inflation, but all experience says that when you get too close to the edge, people suddenly shift their psychology, and then it is too late. That is why one of the grave concerns of this country, with its world-wide responsibilities, with its vast and varied defense needs, beset by all the difficulties caused by wrong policies in the post war years and burdened down by a vast debt must be

alert against inflation. For the sake of the dollar? Oh, no! For the sake of people in business? Oh, no! For the sake of financiers? Oh, no! Rather for the sake of the freedom of the people of this country and for their enjoyment of life and their children's enjoyment of life! We must be alert to the importance of the stability and soundness of the American currency as a foundation stone of freedom and democracy.

The second main point in this matter of maintaining lasting freedom that I particularly want to discuss is: If there is to be vitality and productivity in the long-term economic development of a country, then it is of tremendous importance that we have in that country substantial pools of investment capital in private hands with the right of private citizens to invest it as they see fit without permission of anyone from government.

Here again many tragic experiences throughout the world reveal what happens to an economy when the only way a business can really develop and expand and realize its potentialities is through the kind permission of men in government. This again is a question that goes beyond any political party; it goes to the fundamentals of government.

You can study the record in the European countries, you can study the record in the Asiatic countries; and when you see in private hands substantial pools of capital, whether they be controlled by individuals or by groups of individuals organized through some form of association or by pooling through banks, or however the control is exerted; when you see in private hands pools of capital, and risks being taken, and money being invested without permission being asked of anyone in government; then you see an economy developing, you see productivity expanding because of self-generating initiative. On the other hand, when you see men in government, regardless of how well-intentioned they are in the beginning, exercising control in one way or another over all the major sources of capital, then you see an economy beginning to wither, productivity beginning to decrease; and with these beginnings come the multiplication

and the acceleration of the inflationary pressures of a country.

These then are the two specific things that I lay before you for your consideration and attention in your own individual activities. I realize fully well that in a free society policies of this kind are actually decided, not by political parties, not by public officeholders, but rather by the people. The people make their decisions in that intangible but definite way in which public opinion takes form. The decisions are made when the great body of the public is influenced by the intelligent leadership that shows itself in discussions by those who are best informed. You, I must point out, are a segment of the best informed public. And therefore when financial subjects are being considered, your counsel and your informal discussions at luncheons, dinners, bridge parties, golf games, or wherever you may be, play a part in developing the public opinion of America on the essentials of financial policy, and by contributing to that development you are affecting the future decisions of both political parties and of America.

Now, I will just briefly touch upon other things that, in this economic field, are so essential for freedom. As you observe what happens around the world, the firm conviction comes to you that it is tremendously important that the farms of a nation be owned and controlled by the men who till the soil and not by the men of the government. And it is tremendously important too, that the professions of a country, particularly the medical profession, be independent professions and not strait-jacketed bureaucracies under a socialistic scheme of nationalized medicine or socialized medicine or any other kind of nationalization of the professions of a country.

Similarly it is tremendously important that the schools of a country be under local control and not under a central, nationalized control, whatever the form of government.

It is also important that the great basic industries—steel and chemicals, oil and utilities—should be in private hands and not in the hands of the men who run the government. In some of the countries of

the world, here is one of the first places the nation is lured into socialism, because nothing is easier than for the demagogue to point to some huge industry, something remote and not understood by the people, and say, "We just want to take this over for the benefit of the people." Once it is taken over, the additional power that that act places in the hand of men in government leads to other powers being sought by those men in government. Even though those who first take over an industry may be sincere, history shows that those who subsequently come into government and control the industries use that power to take more economic power from the people. And once the balance shifts so that the major power of the people in economic matters has been shifted to the men in your government, then other freedoms are soon lost.

Let me also call your attention to one more example of the way in which the first step to the loss of economic freedom has been taken in some countries. Or rather, let me state it this way: that for the maintenance of lasting freedom it is tremendously important that the retail stores of the country be owned and operated directly by the people as private citizens and not by men in government.

And finally, of course, and most important but inseparable from the rest, there are the traditional rights of freedom of speech and of the press, freedom of voting, and freedom of religion. These freedoms must be maintained. Freedom is precious, freedom is indivisible; and I trust we never forget that if men become dependent on decisions by other men in government, as to what they may eat and what they may wear, as to where they may work and what they may earn, as to what they may build and what they may fabricate, as to how they may invest and how they may profit; if that day comes, then this precious freedom is soon lost, or is already lost.

In spite of present world trends and the problems of economic systems affecting freedom, I say to you that I appear before you today with optimism and I am still confident in the future of our America, a nation of people who have true freedom.

CHARLES E. WILSON became Director of Defense Mobilization in December, 1950, after ten years as president of General Electric. He has also been vice chairman and executive vice president of WPB, and chairman of the Civil Rights Committee and Advisory Commission on UMT

## *Mobilization—Where We Stand and Where We're Going*

Charles E. Wilson, Director, Defense Mobilization

THE BRAINS AND THE SKILL of certified public accountants touch the defense mobilization effort at many points, just as they did in the days of World War II. As a member of the War Production Board, I know how the Institute and its members helped procurement agencies on contract negotiation, cost definition, renegotiation, and termination. You also helped prepare accounting manuals for the Armed Forces and government agencies. You helped Selective Service and the War Manpower Commission in the allocation of accounting personnel. You aided the Office of Price Administration to formulate its financial reporting procedure.

In the simpler days of our nation, way back in the eighteenth century, a man could count on his fingers, or use an abacus. But now we deal in figures that are borrowed from astronomy. You accountants are needed to see that astronomy does not degenerate into astrology.

In the course of many years, as an officer of that little company I was connected with, I became accustomed to thinking in terms of millions of dollars. But now I must think in terms of billions. I haven't been able to become used to it. I find myself saying "millions" when I mean "billions." I haven't been in Washington long enough to get used to billions—let's hope I won't be there that long. It's really hard to understand what one billion dollars means. Do you know that spending one billion dollars means spending one

dollar every minute since the birth of Christ, minus 49 years?

In round numbers, the cost of defense mobilization will be fifty billions a year for three years, or one hundred and fifty billion dollars. It is difficult to visualize just how much that is. Our national debt is approximately 250 billion dollars. To put that in another way, it is one-fourth of a trillion. Most of us still shy away from that word "trillion." Yet, to use a more comforting figure, the total value of goods and services produced in the United States last year exceeded 300 billion dollars. It was close to one-third of a trillion. Along with these Buck Rogers figures come complicated laws and regulations which need trained interpretation and calculation. In the last ten years, the number of CPAs has almost doubled, but the demand for them is still growing.

Defense Mobilization has produced many new accounting problems, and I know you would like to have me tell you how best to cope with the orders of the Office of Price Stabilization and the rules of the National Production Authority. You would like to know the most efficient way of applying for a certificate of necessity for rapid tax amortization. You would be glad to have a thorough explanation of the procedure in wage and salary stabilization. You would like to know if all your bright young men are going to be taken by Selective Service, or whether deferments will be granted. You

would appreciate information on how to advise your clients to cooperate in the defense effort.

I feel, however, that you are even more interested in getting from me an over-all look at defense mobilization—where we stand and where we're going. We are living in an age when anything can happen—and usually does. We are fighting a good-size war against communism in Korea—yet it is only one of many places in the world where trouble already exists or is threatened. The French are fighting Communists in Indo-China, the British in Malaya. In addition to open warfare, the free countries are being attacked by infiltration, subversion, espionage, and deceptive propaganda.

All of this fits into a pattern of world conquest as dreamed up in the Kremlin, because, as Stalin has said, quoting Lenin, our kind of civilization cannot live side by side with the Soviet Union. We have tried to deal with the Communists in numerous ways, but without success. They have broken promises, flouted treaties, and scorned civilized usages. The Communists helped organize the United Nations at San Francisco in 1945, but ever since then their actions have been calculated to harass and defeat the UN's efforts to bring about harmony among nations.

A classic example of the difficulties of dealing with Communists is the exasperating course of the truce talks at Kaesong. They began early in July, nearly three long months ago, and there is still no sign of settlement. Armistice talks in World War I consumed only five days. Two days' negotiation were enough to bring about cease-fire order in Europe in World War II. Four days' talk brought about the end of shooting in the Pacific. But after nearly ninety days of palaver, the Korean war still goes on. It has long been obvious that the only diplomacy that impresses the Communists is the diplomacy of strength. If the United Nations had not used its strength in Korea, that unhappy peninsula long ago would have been taken over by the Reds, and their huge armies would have been released for use elsewhere.

We are now building America's industrial power to equip a mighty Army,

Navy, and Air Force, and to assist our allies in the free world to strengthen their defenses. We are also creating production lines and standby facilities that can be brought quickly into action in any emergency. At the end of this three-year period, we should be strong enough not only to meet any challenge, but to discourage any challenge from being made. For the supreme objective of defense mobilization is not to fight a war, but to prevent one. As I have often said, the nation is taking out an insurance policy against World War III.

There are those who fear that the result of an armament race is likely to be war, rather than otherwise. But if we look back at history, we find that war has often been the result of unpreparedness. In 1939, neither England nor France was prepared for the war that Hitler started, and it may well be doubted that Hitler would have dared to precipitate World War II if they had been well-armed.

In any event, what alternative do we have except to build America's might? A fat, lazy, and militarily weak Uncle Sam would be duck soup for Soviet Russia. As General Nathan F. Twining, Vice Chief of Staff of the U. S. Air Force, said in a recent address: "Among nations as among men, the best protection against a criminal is the power and the determination to strike back swiftly and decisively. Today the people of the United States have the determination and they are building the power."

Defense mobilization is now moving into high gear. The first half of 1951 was devoted largely to contract-signing, the drawing of specifications and blueprints, the tooling-up of industries, and the other birth pains that are the necessary preliminary to mass production. In the three months from July through September, deliveries of military goods totaled more than five billions. This was four times the rate just before Korea.

This is a stream that will soon become a torrent. We are getting heavy and medium bombers, light and medium tanks, guns of all kinds, electronic fire control systems, various types of rockets, while the Navy has completed modernization of

a number of warships. The delivery rate from here forward is plotted on a constantly ascending curve. It will reach a peak of \$4 billions a month in the first half of 1953.

You saw production miracles during World War II. You are about to witness them again. You will see not only volume production in the best American tradition, but you will also see the result of superior methods and new technological processes developed since the last war ended. The new weapons will have refinements in operation in the interest of speed and accuracy, as well as unbelievable punishing power.

Of course, we are having some temporary disappointments and difficulties. Of course, we are having to smash bottlenecks and to cope with scarcities. You know how we had to move in various ways to overcome the shortages of machine tools, which lie at the very heart of any mass production effort. The machine tool industry fell into the doldrums at the end of the war. It needed price incentives, super-priorities for raw materials, and new manpower. It is getting these things, so that it may attack its backlog of orders with vigor and confidence.

The scarcity of raw materials, particularly metals, is a continuing problem. This was foreseen and long ago we took steps to increase the supply of steel and aluminum. Part of our scarcity problem arises from the expansion of these industries. It takes steel to build new steel and aluminum plants. But this is bread cast upon the waters, and it has already begun to return to us in the form of increased production.

Copper presents a special problem. Our entire domestic supply, plus what we are able to buy from Chile, is not sufficient to meet our needs. We are seeking new copper development in Nevada, Arizona, South America, and Alaska, but it will be a long time before the metal from these sources will begin to flow to industry. In the case of rubber, imports of natural rubber are being largely augmented by our synthetic plants. Oil drilling and refining goes on at an accelerated pace, and large increases are being made in power

production. Thus, to meet the demands of defense mobilization, we are increasing our entire productive base. This is just another example of the dynamic quality of the American system, and of its ability to spurt ahead under pressure.

Not many years ago, there were those who contended that our economy had already reached a condition of maturity. That implied that arterio-sclerosis was about to set in. How false that diagnosis was is shown by the record of the last decade. First, we accomplished the stupendous task of production for World War II, providing for our huge forces both in Europe and in the Pacific, besides sending billions of dollars of goods to our Allies under lend-lease. Next, we confounded the so-called experts who predicted a recession after the war. Instead of the long line of unemployed that was forecast, industry and commerce moved smoothly from war to peace production and, instead of post-war depression, we had a post-war boom. The year 1950 was a record-breaker for civilian production.

Now we are rearming on a gigantic scale, and we are able to do so while maintaining civilian production at high levels. When all of the new expansion plans have been completed and are in place, we shall be ready to write a new and glowing chapter in the history of the Industrial Revolution. Barring another world war, the future of America can be splendid and magnificent. Our people can enjoy even higher standards of living and the fruits of our industrial progress can spread throughout the world.

But at this point I must warn that, if we are to enjoy material benefits, they must be accompanied by spiritual values and by rugged qualities of character. We cannot accomplish the objectives of defense mobilization without sacrifices and restraints. As military production bites deeper into our capacity, there will be temporary shortages of civilian goods. Higher taxes will have to be paid. Regulations regarding prices and wages will have to be observed. Individuals will have to make decisions of many kinds concerning their own actions, and the question they should have constantly in mind

is: "Will it help or harm the nation's effort?"

The defense mobilization program could be wrecked by runaway inflation, and whether or not we have runaway inflation depends to a large extent on the policies of the large pressure groups—industry, labor, agriculture. Will they use restraint or will they jockey for individual advantage? Will they accept reasonable prices and wages, or will they seek to upset the balances that the government is trying to achieve in the interest of stabilization?

We are now enjoying a period of relative calm on the price-wage front. The freeze order of last January has had the most salutary results. In the last seven months the consumers' price index rose less than 1 per cent. Of course, other factors besides the freeze order have contributed to this result, such as the piling up of huge inventories and the fact that people are saving instead of spending. But the January freeze, however imperfect it was, had a tremendous psychological effect. When people believe that prices will rise, they will buy even if they don't need the goods. If they see prices steady they are more willing to buy only what they need.

Whereas there were no real shortages when the 1950-1951 panic buying occurred, we are now entering a period when inflation pressures will be real rather than psychological. There will be fewer things to buy and more purchasing power in the hands of the people. Then will come the real test of the numerous safeguards that have been erected against inflation.

I am happy to say that Congress is now reconsidering some of the weakening amendments that were added to the Defense Production Act when it was passed last July. One of these amendments tends to upset the whole price structure, as applied to manufacturers, which the Office of Price Stabilization has worked out after many months of careful consideration. It has been called an accountants' dream. I think it should be called instead an accountants' nightmare.

I have complete confidence in the nation's genius for production. If, at the same time, we can exercise the restraints

and the self-discipline to keep the economy stabilized, we will have met the test imposed upon us in these critical times.

I have spoken of spiritual values and I don't know how better I can explain what I mean than to repeat to you an eloquent statement I heard at New York University last June. The speaker was Acting Chancellor James L. Madden. Mr. Madden told the blessings that had been heaped upon our country and he said: "There must also be a revival of spiritual values in our daily lives, if our industrial mobilization is to be fully effective. As America has been growing over the years, too many of our people have drifted from the religious concepts of their forefathers. They failed to realize that no nation can be truly great which lacks spiritual strength.

"Men will die for their spiritual beliefs because of their implicit faith in the Almighty. Accordingly, now is the time for a revival of interest in the faiths of our fathers, and for greater efforts to put into daily practice the teachings of our respective faiths. America's greatness traces back to God-fearing men and we, like our forefathers, should ask for His blessing and guidance in our efforts to safeguard our country and to build even more solidly for the future. Let us keep in mind that Benjamin Franklin once said: 'God governs in the affairs of men.'"

So our defense mobilization is not a slide-rule operation or one whose beginning and end is to see how many weapons of war can be turned out of our factories. It is an exercise of faith—faith in the right of man to enjoy the precious qualities of freedom and justice. We can no longer take freedom or justice for granted, as gifts handed to us by the blood and sacrifice of our forefathers. The lights of freedom and justice are going out all over the world where the shadow of Communism has fallen. We are going to have to fight and strive to keep them alive, because without them life is not worth living. If the nation will tackle the task of defense mobilization imbued with that great ideal, there need be no fear about the outcome.

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## *Accounting in Price Stabilization*

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Paul M. Green, Assistant Director, Price Stabilization

THE IMPACT OF THE DEFENSE PROGRAM on civilian economy is unbelievably great. You just cannot go into this sort of defense effort without having great effect upon your work as you go among your clients and as you prepare the reports and do the work of your office. It is certainly true that runaway prices mean runaway costs, for both the military and civilian activities of the government. Former Secretary Marshall of the Department of Defense pointed out that several billions of dollars have already been lost in the defense budget simply through price increases. Ships and planes and tanks and guns are lost just as effectively through price increases as if they were lost on the sea or on the field of battle. The Russians are counting on inflation to ruin and demoralize us so that their agents can take us over from within. In my opinion, America can be invincible if the economic and the industrial systems are maintained on a stable basis. In language that you and I understand, accountant's language, I think we can put it this way: that our greatest asset is a stable economy.

The subject of this session is mobilization problems. I am supposed to talk about problems that we have in our part of the mobilization effort in price stabilization and in accounting for price stabilization. Certainly we do have problems; we have many diverse and great ones. We have the problem of getting enough

people in something so unpopular as price control, price stabilization, something so uncertain at the moment. It is extremely difficult to get really good accountants willing to come in, to take such a heavy responsibility, and to take the pounding that they have to take as they try to do their work.

We have a problem in getting people to understand. Accounting-wise, OPS works with the problems not of one company, not of companies in one industry, but with the accounting problems of practically all companies. It is difficult for the accountant who comes to see us about his own particular client, or the businessman who comes about his own particular problem, to understand that the decisions we make, the policies we follow, and rules we make, have to be so designed and so administered that they will serve for all companies.

I report that our greatest problem on these critical issues is to get a simple objective statement of the truth. What we need, and need so badly, is the truth, the whole truth, and nothing but the truth.

The accounting operation in OPS is administered through an office of accounting. It is one of eight components in the agency and it stands on equal footing with the other components of the agency. We have accountants stationed in each of the types of offices that the agency has. In the national office, at



the present time, we have about 150 accountants. We have a budget of 300 there. We have 14 regional offices, 13 for the continental United States and 1 for the territories, and there are accountants stationed in each of them. We have, at the moment, I believe, about 85 district offices spread throughout the United States and some of the territories, and there are accountants stationed at each of them. I will not say much about how we work beyond that, except to say that, in OPS accounting, we have to operate as an accounting firm. Some of your firms have worked with us in one way or another and I think you generally understand. We believe that there are certain principles we must follow. In other words, we are not, we hope, just floundering; we think that there are certain principles that we have to follow. First of all, before we can do anything, we have to be sure of this independent position of accounting; that is the only way we believe it will work. We have to fight off any attempts to infringe on that independence. We have had our difficulties and we shall probably continue to have them, but we have had great and strong consistent support from the Institute.

We are responsible for all accounting. In other words, accounting decisions that are made in Seattle, San Francisco, Minneapolis, Boston, or Washington, are made under the same set of rules of procedure, and we hope that they are consistent. We rely on generally accepted accounting principles consistently applied. Those are old words but they are important words. We do not try, and will not try, to tell any company how to do its accounting. That is not the function of OPS accounting. Attempts have been made to jockey us into that position but we have so far successfully resisted them.

We believe it is a basic right of the accountant to set forth the facts as he finds them, and we believe further that the OPS accountant has as great freedom to enjoy that basic right as any accountant in the world today. That is a strong statement, but we believe it to be true. We believe that the freedom to enjoy that right, to set forth the facts as

they actually are, as he finds them, is just as great in OPS accounting as it is in your own particular firm.

We believe it is important to maintain sound and consistent accounting policy. In other words, these accounting decisions cannot be made one by one. They all have to be made within a framework of accounting policy and we believe further that if that basic policy is sound, and if our accounting executives make their decisions within the framework of that policy, it will not matter how many years later we come back to review that question, or to look at the problem again; given the same set of facts, and following the same good accounting and good judgment, the answer will be the same. I constantly tell the members of the staff, "If you can operate on that basis, you don't have to worry about investigations, you don't have to worry trying to remember what you did." It is almost identical with telling the truth. You don't have to remember what you said. We don't have to remember what we did. Given the same set of facts, we are reasonably sure we will come out with the same answer whether it is one year later, two, ten, or twenty years later.

Accounting is growing in importance in the administration of price control or price stabilization. Early attempts at price control, both in OPA and in OPS, involved the freeze technique where you simply say that prices are frozen as of a certain time. You know, and I know, that that does not call for any accounting. There are no accounting problems in that method.

From that we get into industry surveys where we go out to a hundred companies, possibly—sometimes, when we get into retailing, we get as many as a thousand companies. We go out and try to pick up their costs, bring them to the particular office working on the case and get them out so that the price executive has some basis on which to take his action. Those studies are made (I insist) objectively because we don't know what the answer is supposed to be and we are not trying to develop accounting facts to back up or prove anything. We are

trying to find out what the facts are. We also review submitted cost computations. When your clients send in their figures to OPS, in all probability, someone in the accounting department will take a look at them. We handle individual hardship cases where somebody cannot live under present regulations and he asks for relief. We do accounting for enforcement examinations and it is important I think, that the enforcement investigators, enforcement executives, and the accountants are separate and distinct. We also are responsible for maintaining agency accounting policy.

Now, as to our problems, I cannot cite all the problems we have, but I can cite a few of them for you. We might ask at what cost level should price control be administered. Should it be on the basis of direct material and direct labor? In other words, direct cost or primary cost? Well, we undertook to do that and we called some twenty-five leading comptrollers to Washington and, in an all-day discussion, we asked them if they could identify direct material and direct labor. If you read the cost accounting text books, of course that is the foundation of cost accounting. I suppose you call it the foundation of cost accounting. These twenty-five comptrollers said, "No, we can't, in our companies, identify direct material and direct labor." We submitted this proposition to them: If you were to throw all your costs up in the air and let them come down to the table, wouldn't the direct costs fall in one pile and the indirect in the other? They thought about that for awhile and then they said, "No, this is not true. If you throw them all up in the air they will come down and it may be possible for you to separate them into two groups but we do not believe that our companies can separate direct material from indirect material or direct labor from indirect labor."

As a result of that we came out with Regulation 22. I don't want to cite regulations here, but that one is so important that I shall have to mention it. It is based upon almost total material cost and almost total labor cost. In other words, it spills over direct cost to a point beyond and gets

into the indirect factory expense. Do we stop there? Maybe not. Maybe we go to a factory cost. Do we stop there? Possibly not. We go on to the total cost. That is one type of problem we have.

Another type of problem is, do we work with the whole industry, or do we bring it down to one company and then do we work with the whole company or do we bring it down to one plant or one division, or do we bring it down to a product line such as refrigerators, or do we bring it down to a single product?

Another problem is, at what point does hardship develop? Many companies seem to feel that they get into difficulty, but what would the ground rules be to determine when a company actually experiences hardship? When the rate of profits does not hold up, or when profits do not hold up in total amount, or when there is a failure to make any profit at all—that is, to break even—or when there is a failure to earn factory costs, or when there is a failure to earn direct costs? Answers to these questions must be found.

We also have a problem of trying to convince people that we are not an agency designed to control profits. We go before the Congress, and we are attacked bitterly because we are attempting to control profits, or so it is said. Of course, the agency points out that it is trying to control prices. That is its purpose. But there is a failure to recognize that revenue, cost, profits, are all part of the over-all picture, and particularly when you get into an industry earnings standard—as we did in OPA and we had until a short time ago in OPS—it is very difficult to keep away from the charge of profit control. I am personally convinced that any attempt to control prices or to stabilize prices, if you will, may be subject to criticism, or probably will be subject to the criticism that it is trying to control profits.

OPA gradually—this is the old agency now, the wartime agency—gradually moved toward more and more reliance on accounting determinations. During the war years, you could see this thing develop. There was an increasing reliance upon accounting data. For good or for bad, OPS started where OPA left off. From the

start, heavy reliance was put upon accounting. Current legislation puts the test squarely on accounting. You have all read about OPS difficulties in the newspapers. Current legislation puts price stabilization squarely on the basis of a accounting. It has gone so far that accounting definitions are written into price stabilization legislation. "Upon application and a proper showing of his prices and costs by any person subject to a ceiling price, the President shall adjust such ceiling price in the manner prescribed. . . ." Does that mean one product? Ten products? One company, ten companies, or what does it mean? It goes on to say, and I am quoting, ". . . the term 'Costs' includes material indirect and direct factory labor, factory, selling, advertising, office, and all other production, distribution, transportation, and administration costs, except such as the President may determine to be unreasonable and excessive." Now, as an accountant, how would you like to administer that?

The important thing is not what that statement says (and we could discuss it and argue about it for a long time, I suppose) but that that statement is there. Does that lead to something else? To you, as leading practitioners, I think it is extremely important that that statement is there and legislates (in a sense) accounting. The President has requested the Congress to repeal this provision of the Act. The case is now before the Congress for further consideration.

We have certain difficulties, many difficulties, as we go along trying to get legislation that is workable. We have difficulty in understanding what this provision means. Our lawyers interpret it one way, and then they begin to see that maybe it should be interpreted some other way. As accountants, we get certain interpretations out of it, but the important thing is that it is not clear. It is difficult for us to try to operate on a basis of adjusting the price of each product, on a basis of the total costs of each particular product.

During OPA, where we had experience with 187 thousand companies—and we had something on their accounting records—we found, in 1946, that only 15 per cent of

American companies break down total costs by products. We guessed, at that time, that probably 25 per cent of the production of American companies could be covered on that basis on the theory (or principle) that the bigger companies have somewhat better cost accounting than the smaller ones although, I hasten to add, not as much better as you and I are apt to think. We have no reason to believe that those conditions have changed very much. The National Association of Manufacturers claims OPS overstates the difficulties of breaking down total costs by products. This is at variance with what we have found company experience to be, and at complete variance with what top company accountants tell us.

The top accountants, comptrollers, and financial vice-presidents, come in to talk this over with us and they say, "You cannot do it that way. There are not enough accountants in the country to do it, and the results would not be very reliable." But, when it is set down on paper, the paper statement does not say what the top accounting executives have told us.

Now, there is something wrong. I don't know what it is. It is almost impossible to get an objective statement from industrial accountants on the subject because of the difficulty of separating accounting facts from other facts on the possibility of getting an increase in prices. I think that that is not a good situation for accountants. I think these things have an important effect on accounting and, in order to bring out that point, I want to refer, for a moment, to the field of economics and the profession of the economist.

With the entrance of the federal government into economic and industrial affairs some fifteen years ago, economics became much more important and the economist had a much bigger job to do. There was a tremendous increase, both in the amount of the economic work to be done, and in the importance attached to the economic profession. At the same time there was a rapid increase in the number of persons who became expert economists. They were not economists before, but they saw the opportunity there and they suddenly became experts in the field. Many of the

decisions which have caused us trouble have come from that type of person. It has been increasingly difficult to keep separate economic and political considerations. This has led to the development of a situation in which an economist can no longer feel that he is safe from being branded an exponent of something or other as he goes about his work. In other words, when an economist makes a statement today, he is likely to have the black mark of something attributed to him because he is accused of having some ulterior motive.

There is also an increasing difficulty in getting a completely objective and reliable statement on matters of economics in present-day commerce. Although this situation may have made more jobs for economists, and may have directed more attention to them, in my opinion, it has hurt the profession of economics. You have all seen that develop.

Let us look at accounting. Accounting is rapidly increasing in importance in the affairs of the federal government. The legislation to which I have just referred will show that. There is a tremendous increase in the importance of accounting as a science, and of accountants in their profession. There is a rapid growth in the number of persons who call themselves accountants. Now, just as ten or fifteen years ago, I see this in Washington—you probably see it in other places—you had this crop of expert economists jump up and start to make decisions, you now have expert accountants appearing. Within our agency and in other places, there is a great tendency for people to become experts in the field of accounting who never thought of accounting before it increased in importance. There may now be an increasing difficulty to keep separate accounting and political considerations. Will a situation develop in which the accountant can no longer feel that he is safe from being branded as an exponent of something or other as he goes about his work? There is already some indication of increasing difficulty to get a completely objective and reliable statement on accounting matters from a present-day accountant. If these things come true, it will be a sad day for the individual accountant

and for his professional society, the AIA.

The American Institute of Accountants has helped us as we have gone along. We have relied on many of your firms, your larger firms. We hired six public accounting firms to do accounting work for the Office of Price Stabilization when it looked as though the job was getting too big for us. My decision to use public accountants, in that sense, was reversed by my superiors and we had to call them off before their work was done, but they did come in, and those firms know our problems.

You may be interested to know—I think this is a bad sign, but it happened—that, while one of the most respected firms in your profession was working for OPS, a practicing accountant from a New England state wrote both his State Senators and his Congressman that this was perfect situation for this leading public accounting firm to steal his clients. That came from a practicing accountant and the letters were turned over to us—to our office. It was shocking, but it actually happened.

The Institute has offered to help us in many ways. All during the war, *The Journal of Accountancy* supported objective treatment of accounting data and backed us one hundred per cent, for which I shall always be grateful. The Institute subcommittee on price stabilization has offered its help, but I want to point out that we don't need help so much on the individual regulations—deciding what is acceptable cost and what is not, or how to handle this particular item or that one. We do need help on the broader issues, the broader issues that affect us and affect the Institute.

Just recently I arranged for five leading practitioners, one from each of five public accounting firms, to come to Washington to testify before the Senate Banking and Currency Committee, on accounting truth or accounting fact. These men offered to go through considerable personal sacrifice to do that. When we got to that point, somebody had to arrange for these people to come. In other words, either the Committee had to ask them, or they had to ask to be heard. It seemed to me that the Institute was the logical place to have that request originate. My call was made when the Executive Committee was in ses-

sion, and the request went before that committee. The decision of the American Institute Executive Committee was that this was not a matter on which accountants could ask to be heard.

To me, the important thing is that accounting is so much the foundation of national affairs that someone must speak for it. Someone has to speak for the accounting profession on these matters. I can go even beyond that. I can say that, at the present time, accounting is so important in the international affairs of this Government that it should be of concern to you, to me, and to all accountants. We practice what we preach on that. Some of the people in the audience know of a case where we practically forced the downfall of a foreign government on the right to audit objectively. We finally won our point, but it had to be carried to the point of a cabinet crisis and it almost forced the downfall of a government. We thought, and we still think, that the issue was important enough to follow it that far. We think, and we continue to think, that on these important issues in accounting, somebody must speak for accounting. I cannot help but insist that the responsibility is here and that the opportunity is knocking so loudly it can be heard in many places.

I have certain suggestions, if I may offer them, to the modern professional accountant, growing out of our experience in price stabilization accounting. I hope the accountant will recognize that the great importance of the American industrial system is that it is the great weapon of the free world. It is really the last weapon of the free world—how the American companies operate, and their ability to do things, to turn out these products that are so badly needed. Realize the tremendous importance of professional accounting in

the successful operation of that industrial system! I think the day is past when the accountant can box off a little area and say, "I shall not step outside of that." Do everything possible to support objective treatment of technical accounting problems when they are a basis of national policy and refuse to admit that there is no room for continued and rapid progress in the accounting area.

I think American accounting, particularly cost accounting, has been overrated. I think that it has been given credit for being better than it is. I don't think that it has been given as much credit as it should have for the progress it has made. It is my own opinion that there is just as much room for research, for advance, in accounting and finance as there is in the fields of science and engineering. You hear, and I hear, about the great advances that come in physics, chemistry, and engineering, and what they will do for the world. I insist that the problems and the opportunities are all around us. There is just as much opportunity for research and advancement in the fields of accounting, finance, and management.

In conclusion, I should like to leave these thoughts: OPS accounting needs the full help and cooperation of the Institute and of all its members, and we are sincere in that request. OPS accounting asks for understanding of its problems and the chance to have them reviewed on an objective basis. OPS accounting believes that, if accounting is going to hold its gains and continue to advance as a basis for national policy decisions, leadership must be taken by the American Institute of Accountants. OPS accounting holds that the time has arrived for the American Institute of Accountants to boldly go forth in its most important role as The Merchant of Truth.

W. J. McNEIL is Assistant Secretary of the Department of Defense. In this capacity he has served Defense Secretaries Forrestal, Johnson, Marshall, and now, Secretary Lovett. Before taking this post he was Comptroller of the Navy and is now a Rear Admiral in Naval Reserve

## *Financial Aspects of Defense Mobilization*

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W. J. McNeil, Ass't Secretary, Department of Defense

THE CURRENT PROGRAM of the Department of Defense is being developed and geared to our foreign policy. As General Bradley recently remarked, "Foreign policy is the expression of a nation's instinct for survival. Military policy comprises the practices of a people in the organization of their . . . resources for defense. There is little immediate danger of this country being over-run—but our way of life, our freedom, and our nation have the chance for survival by keeping peace in the world."

This is the overriding consideration of our national foreign and military policies. These policies are united in three basic objectives: first, to protect and maintain our form of government and our way of life against any challenge; second, to seek peace by every honorable means at our command; third, to assure peace not only for ourselves but for others. For these reasons we support the United Nations, realizing that world peace is an integral part of American security. These guiding principles govern our actions in Korea as well as in our North Atlantic Treaty efforts in Europe. We joined in the North Atlantic Treaty as a collective defense effort for mutual security. In collective action we multiply our defense strength.

Since June 1950 the efforts of the United States in this collective action have been to build military strength with an intensity of effort equal to any ever

achieved in this country short of total war. The build-up has not been completed but is well under way.

First, I think it might be helpful if we took a look at the primary goal of our present effort. Secretary Marshall in appearing before the Senate Appropriations Committee last December put it this way:

"This is a move to place us in a strong position from which we can go forward rapidly to the extent necessary. This is not full mobilization. This is a raising up of the whole establishment to gain momentum from which we can open the throttle and go very quickly in any required direction. In my own opinion, and that of my associates, the way to build up to full mobilization, if that eventually is necessary, is first to get this partial mobilization program straightened out and put it on a very high level—you might say a high plateau—and to do it as quickly, effectively, and efficiently as possible."

A concise statement of the objectives and the atmosphere in which this initial policy decision was made appeared in a *Washington Post* editorial at the time of Secretary Marshall's retirement—in these words:

"When the present emergency occurred, Secretary Marshall kept his head, and resisted the hysterical cry of the full mobilizers. For that service alone the country owes him a great debt. It was a gamble he took, but it was a statesman-

like gamble. Secretary Marshall did not want to mobilize men with only broomsticks to train with. What he aimed at, and what we are getting, is a steady, coordinated, and harmonious partial mobilization, with the country wedded to a civilian economy as well as to a civilian leadership, and an economy which moreover, can cope with the military services as a permanent rather than a spasmodic customer."

This concept carries out General Bradley's thought that "through proper and sustained preparedness by the United States and with similar efforts by the free nations associated with us, we may avoid the period of an all-out war."

Partial mobilization, under this concept, means the maintenance of a military force in the neighborhood of 3.5 million men. It means providing such a force with modern equipment at the earliest practicable date, together with certain reserve and mobilization stocks. It means also the early delivery of such additional equipment and supplies as would be necessary for them to undertake combat operations if required by action of an aggressor.

As most of you realize, the build-up and support of forces of this size requires the procurement of literally hundreds of thousands of items. The determination of the number of items required for the initial equipment of forces of a specific number of air wings, divisions, or ships is a relatively simple though laborious task. The problem, however, of determining the quantity of items to be procured for combat consumption in Korea, for the maintenance of adequate pipelines, for reserve and mobilization stocks is a tremendous task. Once the total quantities have been determined, individual items must be scheduled for desired delivery dates. Sources of supply and feasibility of production must be ascertained and checked against the availability of raw materials, some of which may be in critical supply. Throughout all of this process the application of good judgment is vital.

In undertaking this program certain ground rules were established. First, the principle was adopted that once the ap-

proved active forces were raised and provided with modern equipment, and current operating stocks were on hand, maximum feasible reliance would be placed on continuing expandable production rather than on huge accumulations of reserve and mobilization stocks, particularly those stocks which might be subject to a high degree of obsolescence.

Accordingly, the basic objective of the military procurement program is to supply the services, the material, and equipment required for the timely accomplishment of the respective missions. In doing so every effort is being made to see that the procurement and delivery of items are scheduled in a carefully planned and balanced manner to meet the actual service needs. At all times the present and future productive capacity of industry is being given full consideration and plans will provide for the maintenance of production lines rapidly to expand if that should become necessary. Planned production schedules for major items of hard goods have been prepared and indicate for each specific item the plants in which the production is proposed as well as the quantity and delivery rate expected in terms of units. Such schedules are supported with data to justify the quantity, the rates of delivery indicating necessity for any departure from a reasonably smooth production curve.

More specifically, the military departments have been directed to adhere to the following criteria in the preparation of these planned production schedules:

1. Schedules must be realistic. Among other things, they are to take into account conditions in regard to availability of facilities, materials, manpower, etc.

2. Procurement programs are to be orderly and are to minimize severe, unnecessary jolts on the economy.

3. Where items are related, the scheduling of the easier-to-get items is to conform to that of the more difficult.

4. The quantities scheduled are to be projected to cover all hard-goods procurement programs financed or to be financed from funds of the Department of Defense as well as the mutual defense assistance procurement programs.

5. Each military department in determining requirements is to do so in sufficient detail to identify requirements for initial equipment, combat and peacetime usage, pipelines, and war reserves, and take into account inventory position and materiel on order, each giving consideration to the potential capacity of projected production lines.

6. In addition to carefully planning production schedules with major programs, the several programs of the three services are to be interrelated one to the other and modified where necessary if the composite produces a requirement for materials, manpower, or other resources in excess of availability.

In order to insure orderly procurement of the so-called soft goods the Secretary of Defense established the following ground rules:

1. Soft goods are to be planned, or scheduled, for procurement only at the rate required to meet valid military requirements and in such a manner that, wherever practicable, production peaking will be avoided by the spacing of deliveries.

2. For items of soft goods for which the total fiscal year 1952 procurement objective for any one military department exceeds \$2 million, no more than one-third of the procurement objective for the year shall be contracted for delivery during any single quarter. In those cases in which the seasonal character of procurement, combat needs, or similar considerations indicate the desirability of contract delivery beyond these limits, such deviations will be authorized by the Secretary of the appropriate military department.

In addition to specific actions which have just been outlined, statutory agencies under the Secretary of Defense, such as the Research and Development Board and the Munitions Board, are to carry out their responsibilities for coordination of the programs of the military departments. Presently a primary responsibility is to see that proper emphasis is placed upon these programs of items which are of the greatest need to the Department of Defense as a whole.

The Munitions Board, for example, is allocating tools and production facilities between the various, and sometimes competing, programs of the services in order that those items having the greatest priority will not be unnecessarily delayed. The Munitions Board also has responsibility for coordination between the services on all procurement matters including the supervision and control over items which the services might otherwise seek to procure in competition with each other.

All of this is being carried out in close collaboration with the Office of Defense Mobilization headed by Charles E. Wilson, the Defense Production Administration, and the National Production Administration—the latter two reporting to Manly Fleischmann. Their task is broader than that of defense alone because it is their job to provide for the proper allocation of production effort between the competing military and civilian requirements for resources. I think you will be gratified to know that, other than the healthy and vigorous expression of differing opinions inherent in a strong democracy, the closest cooperation is being developed—in an atmosphere where men of good spirit are bending their efforts to a common task.

We believe that the basic objectives and intent of our plans are sound. The translation of these basic objectives into the hundreds of thousands of items is difficult. However, by taking advantage of the lessons learned through the making of costly mistakes in World War II, and utilizing the experience of competent personnel who tackled similar problems during that period, early action was taken to make a thorough analysis of requirements and translate the results into realistic schedules. The first results of this effort were reflected in the 1952 budget request of the Department of Defense where, as you may have heard, the initial requests, as expressed in dollars, were reduced from \$104 billion to \$60 billion, by the elimination of the duplication of items, pricing, reduction in estimates of quantities required and the phasing of deliveries.

Subsequent to the submission of the budget a re-review was immediately undertaken. This will be a continuing process—



in fact a substantial number of the schedules have already been revised. Sufficient progress has been made in the technique to justify the statement that since January—when the expanded program was decided upon—more constructive work has been done in analysis of requirements and scheduling than had been accomplished by the end of 1943 in the World War II period. A great deal remains to be done and we are not satisfied but we believe that we are on the right track.

Let me give you an example of the application of the analysis and scheduling process by using hypothetical requirement figures for a specific item which is required by the Army, Navy, Marine Corps, Air Force, and which is also being provided for the free nations through the Mutual Assistance Program. Assume that computed requirement of jeeps to provide sufficient quantities for Korean combat consumption, for the initial equipment of the forces being activated, for pipeline requirements, initial mobilization stocks, and combat requirements for an all-out war might total 400,000. An analysis of these requirements might show that some 50,000 were necessary for initial equipment and current use of the active forces. Another 50,000 might be necessary in order that units which could be deployed in combat would have a full pipeline and immediate support. This 100,000 figure would be considered an immediate requirement but we could get by on this limited number only if production and expandable production lines were in being. As deliveries approach this total we could depend on expandable production lines for our mobilization and combat requirements.

In this particular item production was almost nonexistent a year ago. Today production has reached a satisfactory rate. This rate will probably be continued for another year, after which we would expect to keep multiple expandable sources producing at a minimum rate. Thus we could avoid the accumulation of large and unnecessary stocks of war and mobilization reserves. In many items of military equipment, such as aircraft and electronics, this practice could avoid the losses which result from high rates of obsolescence.

Such reasonable immediate requirements might avoid the necessity for large scale conversion of industry, raw materials are conserved, and there is a lesser immediate need for the taxpayer's dollars.

As of the moment few items have reached this satisfactory production rate. In some major items, such as aircraft and tanks, it will be months before satisfactory production rates are achieved. As rapidly, however, as planned production goals are achieved we would expect to apply the principle outlined in the jeep example to each major item of equipment included in the military procurement program.

A moment ago I mentioned the objective of providing modern equipment for our increased forces. The term "modern" would apply to new trucks—it would apply to new jet aircraft, which are a far cry from the slow, propeller-type aircraft being delivered to the armed services in 1941, to new fire control, guns, and improved types of ammunition.

Recent publicity about new weapons, new developments in warfare, and optimistic statements on the military application of atomic energy may have given the exaggerated impression that a quick, easy, and inexpensive security might be now at hand.

Fortunately, there is enough truth in both the weapons developments stories, and in the progress reports on atomic energy to encourage a very optimistic outlook for improved American armaments. However, until new weapons and new military applications of atomic energy are available for field use, our national safety in the face of attack depends upon the improved conventional weapons, in ample quantity, and with sufficient trained and equipped ground, naval, and air forces to use them effectively. As the developments now in progress indicate that scientific, technical, and engineering problems are being solved, the new weapons are becoming complementary to conventional weapons, and will eventually replace certain types, to the ultimate improvement of our over-all defense program.

Our present research and development programs, and our present weapons pro-

curement programs including those in the 1952 budget, are taking full advantage of promising developments. The procurement programs, and the research and development programs now being projected for future years, are also directed toward this end.

Many future weapons may be dramatically different from our present armaments. However, I would like to repeat that we must rely upon proved, tested, and available models to win today's battles with the men presently trained to use them. As Secretary Lovett recently remarked, "A guided missile on the drawing board or at the proving ground can't win 'Heartbreak Ridge' in Korea tomorrow morning."

While, so far, I have emphasized matters relating to the administration and management of the current program for building military strength, it does not mean that we are overlooking the long-term need for installing improved business practices throughout the Department of Defense. A good start has been made, under authority recently granted by the Congress. To me the potential benefits, both to the government and the taxpayer, are exciting and fascinating. Actually, our plans contemplate nothing particularly new except the application of proven business methods to the financial operations of government. The operations of commercial-type and industrial-type activities—for example: manufacturing arsenals, navy yards, overhaul activities, printing plants, clothing factories, coffee roasting plants, and so on—are being isolated and removed from the mass of appropriation accounts. When so isolated each such activity is given a charter similar to that which a state would give to a business corporation. Each activity is provided with its own working capital and with a separate bank account. From that moment on its operations—manufacturing, accounting on accrual basis, costing—are handled in a manner similar to those of private business enterprises with the end product costs being billed to the military organizational units which are the customers of these activities.

Also, inventories of common-use standard-stock items are being placed under item and dollar control. Such inventory

operations will be carried on—within the framework of the military departments—in a manner similar to those of a Sears Roebuck or a Montgomery Ward, stocks of items being maintained for issue with the costs thereof being billed currently to using activities thus making readily available a current measure of consumption, and providing effective inventory control.

I wish that time permitted a fuller description of the Department's plans of this nature—and of the tremendous possibilities inherent in the application of modern business principles to government operations. We hope some time, in the not too distant future, that we will be able to tell you a story of accomplishments that will increase your confidence in the ability of the Department of Defense and the government properly to manage its business.

So far I have been speaking of the defense program in terms of forces and production. The program may, however, have more significance to this professional group if its scope were expressed in terms of dollars.

July 1 a year ago almost coincided with the outbreak of hostilities in Korea. At that time the Department of Defense had a little over \$8 billion of unspent funds to its credit in the Treasury. During the following fiscal year (1951) Congress provided \$48 billion, making the total available over \$56 billion. During that fiscal year, which ended three months ago, the Department of Defense actually spent \$19 billion, leaving about \$37 billion to its credit in the Treasury at the end of the fiscal year.

For the current fiscal year Congress will probably appropriate approximately \$62 billion, not counting a contemplated supplemental sum for Korean combat consumption. Adding the \$37 billion carried over from previous years, the total available to the department for the year will be close to \$100 billion.

I have mentioned several times the funds carried over from year to year. For the most part, these carry-over funds represent the value of undelivered equipment and material. For example, contracts for aircraft placed in 1951 may provide for deliveries in 1953, the manufacturing or

construction lead time varying from 18 to 24 months on aircraft and as much as three years on heavy ship such as the new aircraft carrier, the USS FORRESTAL. In this connection I would like to emphasize that the beginning of any major military build-up, a considerable portion of the appropriations provided and contracts placed are in the nature of a capital investment. Once such major capital investments have been made, the plateau of which General Marshall spoke can subsequently be maintained at a lesser appropriation level than when the program initially is undertaken.

Separate and apart from funds appropriated to the Department of Defense is the military portion of the foreign aid programs. There was \$5 billion in unspent funds to the credit of this program on July 1. The Congress will probably appropriate \$6 billion for the current year, making a total of \$11 billion currently available. This amount added to the funds available for the U.S. military forces makes the total available for all military purposes something over \$110 billion, of which some \$44 billion is expected to be actually expended during the current fiscal year. The carry-over of unspent funds into the next fiscal year for the Department of Defense and the Military Assistance Program will be about \$66 billion.

The amount of funds to be requested for 1953 has not as yet been determined, but regardless of the level eventually decided upon, the actual expenditures in 1953 will be somewhat higher than in the current fiscal year.

In the federal budget certain items closely related to defense are not included in the figures that I have just recited. Funds for stockpiling of critical materials, the Maritime Commission, the Atomic Energy Commission, and for the government's investment in increased natural resources call for an expenditure of some \$4 billion. Estimated expenditures for other government agencies and interest on the national debt will total about \$17.5 billion.

While we are on the subject of dollars the distribution of effort within the Department of Defense by major categories might be of interest. A moment ago, I mentioned that the Congress would probably provide in our regular budget request about \$62 billion. Of this total about \$10.5 billion will go for the pay, allowances, subsistence, clothing, and transportation of military personnel. About \$13.0 billion will be allocated to "Operation and Maintenance". Of this total some \$4.5 billion will go for the salaries and wages of civilian employees. The balance will go for fuel, oil, spare parts and other supplies for posts, camps, stations, aircraft, ships, and military equipment.

A little over \$31 billion will go for the procurement of major items of equipment such as aircraft, ships, combat vehicles, artillery, weapons, and ammunition. About \$4.5 billion will go for the acquisition and construction of posts, camps, airfields, warehouses, and piers. The pay and allowances and training of the National Guard and reserve forces will take about \$700 million. Research and development will take another \$1.5 billion. Joint activities, together with retired pay and miscellaneous items such as caring for the prisoners of war, will take another \$500 million.

These sums are substantial but unfortunately because of the tensions existing in the world today we can expect defense expenditures to continue to be heavy in the coming years, requiring sacrifices on the part of all of us. The Department of Defense will do its utmost to carry out the program for building up our military strength in such a manner as to merit the confidence of the country and to make the burden as bearable as world conditions will permit. There are two good reasons: first, we too are taxpayers and second, we fully realize that the more bearable the burden, the greater the chance for maintaining adequate defense so long as necessary for the security of this great country in which we live.

Brig. Gen. T. R. RAMPY is Auditor General of the Air Force. It was as a civilian that he first brought considerable accounting experience to bear on the Army Audit Division in Washington. He was commissioned from civilian to Lieutenant Colonel, and in 1948 went to the Air Force

## *Auditing in the Air Force*

T. R. Ramp, Brig. Gen., Auditor General of the Air Force

“AUDITING IN THE AIR FORCE” is a very appropriate topic for discussion before this meeting of accountants, as it deals with the proper stewardship of public funds. Billions are being appropriated for our greatly expanded preparedness program, which will have a serious effect on our national resources. Shortages will develop in many areas. We are compelled, therefore, to make the most efficient use of materiel and personnel so as to exact the maximum military strength from every dollar expended on behalf of our defense efforts. The auditing organization of the Air Force is imbued with this concept. In fact, its members are continually stressing the importance of getting the “most for our Air Force dollar.”

Everyone recognizes, of course, that the word “auditing” as used in everyday conversation, implies the examination of financial transactions. It is not so clear, however, that auditing also has economic implications. When we consider that the annual and other reports of audits of accounts and financial records of the business world form the basis for important decisions by business management, we cannot fail to appreciate the invaluable role of auditing among our modern business practices.

Turning to the subject of auditing within the Air Force, let us consider the why, what, and when of Air Force audits, as well as something of the how from a technical and manpower standpoint

which, I am sure, will be of interest to you and every other taxpayer.

You have heard today and on various other occasions, discussions of the comptroller systems of the Department of Defense, and of the Army, Navy, and Air Force. It has been emphasized that one of the objectives of the comptroller in the defense establishments is the development of better management practices. It is understood, however, that the word “management” has such a broad meaning that it cannot be copyrighted by any one organization. Therefore, it is not always a simple matter to explain just what a comptroller does that is termed “management.” It is relatively simple to mention that a comptroller has responsibility for budgets, finance, accounting, and auditing. Broadly speaking, it is with these financial activities that the comptroller may find the means of making recommendations or developing procedures which will produce better management practices. My particular interest lies, of course, in the auditing field.

The comptroller of the Department of Defense has stated that it is his policy that auditing should be performed as an independent function at all levels of command as a direct responsibility of the comptroller of the service. The Air Force established the Auditor General as part of the comptroller organization of the headquarters in Washington, effective July 1, 1948.

The Auditor General, therefore, has direct responsibility for performance of all auditing activities throughout the Air Force. This requires a world-wide organization which, for administrative purposes, is divided into geographical areas designated as "districts". There are six districts within the United States. One is being organized to cover Air Force units in Europe, Africa, and the Middle-East portion of Asia. Another district will be set up later this year to cover units in the Far East, namely Japan, the Philippines, Guam, Okinawa, and certain other Pacific areas.

The auditing activities of the Air Force fall generally within two broad categories. One area is that of the records of financial and property accounting transactions within the Air Force. The other category relates to the audits or examinations made in connection with Air Force procurement contracts.

Actual performance of audits is by personnel assigned to and under the immediate supervision of the audit districts. Over-all policy direction and general supervision are responsibilities of the headquarters staff of the Auditor General. The Auditor General maintains close liaison with the Assistant Comptroller of the Department of Defense, who is responsible for general accounting and auditing policies.

The three audit agencies of the services also have a close working relationship with a view to development and continuation of uniformity in auditing policies and procedures. This relationship includes a coordination program whereby audit responsibility in plants having contracts with two or more services is assigned to a single service. Various factors may enter into this determination, but a major consideration is the dollar volume of contracts of each service which may require some type of audit examination.

I have just mentioned the close working relationship existing among the audit organizations within the Department of Defense. The question is often asked as to how the General Accounting Office fits into the picture. That office, as most of you know quite well, is headed by the

Comptroller General, who reports directly to the Congress. It is a statutory office and has certain responsibilities under the statutes, one of which is the audit of government expenditures. It has somewhat the same relationship to the Congress that a public accounting firm has to the board of directors or stockholders of the corporation whose books it is examining. The General Accounting Office works very closely with the Department of Defense in an effort to avoid and eliminate all unnecessary duplication. You will be interested to know that much progress has been made in that direction.

The audit agencies of the three services have the duty of examining accounts and transactions of the many varied activities within the respective departments of the Department of Defense. By working closely with the General Accounting Office, we are able to develop accounting and auditing procedures which reduce the amount of testing and checking which that office is required to do in order to perform its mission. Therefore, the better we do our job, the less detail work the General Accounting Office has to perform.

At the outset I said that discussion of "why", "what", "when" and "how" we audit might be of interest. The answers may be obvious or even well known to many, but these questions are actually asked by someone in nearly every group I meet. So "why" do we audit; that is, why is auditing considered a desirable thing to do? Broadly speaking of course, we say it is a means of protecting the interests of the government, but why do we think it does this? The answer lies in the direct and indirect results obtained. First, audit determines the accuracy of the records and provides opportunity for correction or improvement where needed; second, it tests the propriety of recorded transactions, thereby providing a means of judging the efficiency and integrity of individuals concerned; and third, the knowledge that periodic audits will be made causes the exercise of greater care in recordkeeping and is a deterrent to improper acts. These results we believe to be real, as does modern business which considers

independent outside audits and internal audit organizations valuable tools of management.

A further logical query then is—"what" in this large, complex, world-wide Air Force is appropriate to be audited? As has been mentioned, there are two broad areas; one relates to inside the Air Force and the other to outside the Air Force, that is, procurement. To be more specific, however, the following are examples of the types of audits performed within the Air Force:

*Property Accounts.* This covers the records kept by persons charged with accountability for government owned property and includes warehouse inventories.

*Fiscal Accounts.* This covers the records of the allotments and obligations of appropriated funds.

*Quasi-official Accounts.* Included in this category are accounts of welfare activities, such as motion picture services, non-commissioned officers' clubs, officers' clubs, and various other activities conducted pursuant to statutory authority and for which commanders have responsibility for proper operation.

*Commissary Accounts.* Involves records covering purchase, requisition, and distribution of subsistence for Armed Services personnel and their dependents.

In the contract or industrial area, "what" we audit is determined primarily by the type or form of contract. Broadly stated, audits of Air Force procurement contracts provide information and data for use in judging the accuracy, adequacy, and propriety of cost statements, cost estimates, and claims for payment presented by contractors. There are many forms of contracts but the great volume of Air Force auditing is related to two general types—one is the cost-reimbursement type and the other is the price-redetermination type. There are, of course, variations in each of these two types, but practically all of them indicate some degree of audit, except that price-redetermination forms of contracts of relatively small amounts do not ordinarily justify expenditure of audit time. It should be understood that it is not now a custom of the Air Force to audit costs

of straight fixed-price contracts awarded pursuant to formal bidding, although in rare instances, an audit might be indicated in the case of a straight fixed-price contract awarded through negotiation.

### ***When Are Audits Made?***

The "why" and "what" have been briefly covered. Now "when" are audits performed? Auditing of accounts within the Air Force, as distinguished from auditing of procurement contracts, is quite similar to internal auditing within a private business. Therefore, when or how often accounts and records are examined by the internal audit staff depends on various factors.

Some of these factors are:

1. Frequency of transactions.
2. Dollar value of transactions
3. Relative importance of the activity, and
4. The established history of the records and personnel involved.

Although we often set arbitrary minimum requirements as to frequency of auditing particular accounts, there are no arbitrary limitations. The minimum requirements can be readily changed to meet changes in circumstances. In some operations, such as the accounts of a commissary, frequent, often monthly examinations are made because of the nature of the activity. A commissary may be likened to a super market, as it handles all those items which make up the family food basket—groceries, meats, and produce. Then there are some activities which are examined only once a year. An example is certain property accounts. Then there are others on two, three, four, and six month schedules. These schedules are not inflexible and when the audit staff or the commanders find reason to think an audit desirable, it can be performed at any time.

There are also varying conditions which govern "when" and how often contracts are audited. Some of the considerations are:

1. Type of contract
2. Dollar amount
3. Rate of production, and
4. Frequency of pricing negotiations.

Under the cost reimbursement and large-scale price-redetermination forms of contracts, it is ordinarily desirable to make what is called a "continuous examination" of the cost records. This may require assignment of personnel to full-time duty in a particular plant. In some cases, the volume of transactions may justify only periodic visits in order to keep the audit work on a current basis. There are, however, many contracts which are examined only at the time statements of costs incurred are presented for purpose of price revision. In case of termination of any type of contract, it is usually necessary to make an audit of the costs or claim of the contractor as an aid in settlement negotiations.

### ***How is Auditing Performed***

I also promised to say something about the "how" of Air Force auditing. It is not my purpose to talk about methods and techniques in detail since we try to follow the accepted practices of the public accounting profession. It may be of interest, however, to consider some of the steps which have been taken to reduce the number of auditors required. The first step was to develop higher standards of qualification of personnel. Progress has been made in that area. Using better qualified personnel, we are able to train them in the use of selective testing procedures and in the exercise of sound business judgment. Although the same principles are being applied in audits of procurements contracts as in audits of internal accounts of the Air Force, so far there has been greater progress in the improvement of contract auditing.

At the beginning of World War II, a great number of large cost-plus-fixed-fee contracts were awarded by the services but there were no guides as to just what was necessary in the form of auditing. There was doubt and confusion, whether justified or not, concerning the requirements of the General Accounting Office. As a result, the government and the contractors did many things which consumed the time and almost exhausted the patience of many people. Gradually, a better

understanding of requirements has developed and greater cooperation among all concerned is evident. In several instances, it has been possible to develop close team work between the internal audit staff of the contractor and the armed service auditors whereby each covers specific phases for a certain time and furnishes reports to the other. This requires a thorough survey and appraisal of the accounting procedures and internal controls, and the preparation of an audit program acceptable to both. Periodic tests must be made, of course, to assure the continuation of an accepted condition. Considerable saving of personnel has been accomplished and better relations exist with the contractors where we have been able to develop this coordinated effort.

It may be well to mention briefly a subject which has been discussed more than any other in connection with the audit of contracts. I refer, of course, to the Contract Cost Principles, Section XV of the Armed Services Procurement Regulation. These cost principles were developed to replace various other cost definitions formerly used, such as Treasury Decision 5000, and the "Green Book". Treasury Decision 5000 was used in cost-plus-fixed-fee supply contracts by the War Department during the war and the "Green Book" was used for similar purposes by the Navy. As most of you know, there were questions of interpretation of these definitions not only by administrative officers and contractors, but also by the General Accounting Office.

The present Contract Cost Principles became effective 1 March 1949. They have been used with little controversy in cost-reimbursement type contracts since that time by the Army, Navy, and Air Force. There has been some controversy as to the application of these principles to fixed-price types of contracts, particularly those with price revision articles. In the absence of any clear definition of cost for use in determining costs under such contracts, the audit agencies of the three services adopted a policy which provides that auditors will segregate costs in accordance with the Contract Cost Prin-

ciples. The auditors are required, however, to recognize any specific contractual provisions. The reports of audits of contracts of this nature are used by procurement personnel in negotiating revisions of prices. It should be noted, however, that procurement officers are not required to use the provisions of the Contract Cost Principles in arriving at a base cost under fixed-price contracts even though the audit report shows a segregation based on the Principles.

One of the points which I always try to cover in discussions such as this is that the Air Force does not, and I'm sure the Army and Navy do not, require specific accounting systems to be kept by contractors. It is the policy to accept the contractor's system with the least possible adjustment. Accuracy and equity in accumulation of costs is the basic principle to be observed. The staffs of the audit agencies of the services are always glad to advise contractors regarding the accounting and auditing implications of their contracts. In some instances, changes in accounting systems may be indicated as necessary, but the services do not provide a specific system for use by any class of manufacturers.

Another and most important phase of the "how" of auditing is manpower. I have mentioned that we have tried to raise the qualification standard and have met with some success, but the number of qualified auditors available are not sufficient to meet the demand, as most of you know. Although the number of auditors employed by the Air Force is not restricted information, the mention of them here would be of little value unless it conveyed some idea of the actual workload. The Congress requires a very detailed justification of our budget requirements. Statements showing the number of Air Force bases, estimated population of each base, and the average number of personnel required to perform the audits at these installations are prepared based on the best available data. It can be readily understood, however, that much of the data needed to make sound estimates cannot be obtained because they must be submitted at least one year before the

beginning of the period involved. With an expanding Air Force, it is quite difficult to find sufficient personnel to meet the needs as they arise. Ceilings and limitations are established by law and by regulation which make the job of adequate performance a definite challenge.

The same procedure and situation applies to the staff available for contract audits. The greatly expanded procurement program of the Air Force has caused a large increase in the number of audit personnel required. As you probably know, present Air Force procurement is at a rate considerably in excess of ten billion dollars a year. This is spread among many industrial concerns in the form of prime contracts of the various types mentioned before. The majority of the dollar amount requires some type of audit examination.

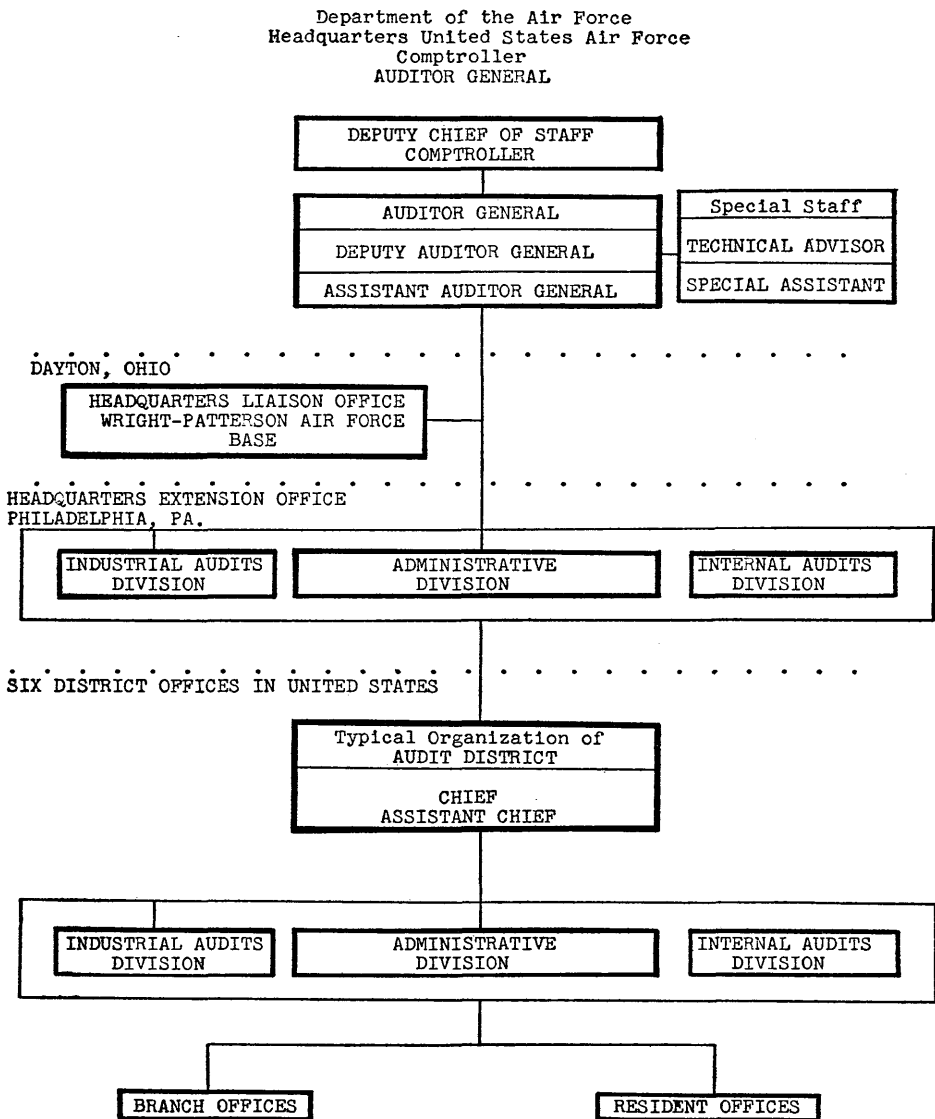
The impact of the expanded program was felt early this year and during the past eight months the audit staff has increased about 100%. The present staff is approximately 2,000—which is made up of approximately 1,400 civilians, 475 officers, and 125 airmen. A considerable number of certified public accountants and members of the American Institute of Accountants make up this complement. Most of the officers are reservists who, according to present policy, will have to be released at the end of 17 or 21 months' service. We are faced with the problem of replacement of these men as well as meeting our present needs for additional personnel. If we must lose the reserve officers now on duty, their replacements should come from the inactive reserve pool approximately three months ahead of releases. In other words, reserves who are now on involuntary recall might be replaced by those who have not yet been recalled to active duty. This may appear to be, and in fact is, a somewhat harsh way of doing things, but the present situation indicates the necessity for sharing the burden. In some cases we could utilize civilians as replacements to whom employers might give assurance of return to their jobs at the expiration of some stated period. These are just ideas of my own and do not represent any established



policy of which I am aware. And, of course, this is only one of many areas where similar problems exist. No doubt representatives of the accounting profession will be called upon from time to time to assist the services in solving this situation which is becoming more acute every day.

Another phase of the "how" of audits in the Air Force is—how do we use all of this talent we have and want? I explained earlier that there is a headquar-

ters staff and an operating staff divided into geographic districts. Each of these districts also has a headquarters office which is responsible for supervision of auditing personnel in resident offices at Air Force bases and contractors' plants, and strategically located branch offices where audits are performed on a mobile basis. The headquarters offices have three divisions: The Internal Audits Division; the Industrial Audits Division; and the Administrative Division. This corresponds



to the organizational set-up of the Auditor General Headquarters.

The six districts in the United States average approximately 300 personnel each. Each headquarters office is headed by a district chief who has a staff of accountants equivalent to supervising seniors and seniors, with the usual clerical assistance necessary to handle correspondence, personnel work, typing, and so on. The primary mission of the district is performance of audits through resident and branch offices. The district headquarters exercises direct supervision over the resident and branch offices, through assignment of personnel, on-the-job assistance, surveys of field performance, current review of reports, and continuous follow-up as to status of work assignments. This includes review for (1) technical competence of personnel, (2) uniformity of application of policies, (3) clarity of presentation, (4) improvement of techniques and wordings, and (5) unnecessary supporting schedules.

The headquarters supervision of the Auditor General in respect to the districts is exercised by the staff located in what is called the Headquarters Extension Office at Philadelphia, Pa. This office operates as a part of the Washington office, under the direct supervision of the Assistant Auditor General, Colonel Kenneth W. Hurst, a member of your organization, who was recalled to active duty about a year ago. The amount of supervision necessary in the operation of an expanding organization with many new employees, is much greater than that required in a long-established, going concern. During this growing period, the amount of supervision given to field activities has, of necessity, been inadequate. It is, however, the responsibility of the headquarters staff to make periodic surveys of district headquarters offices and various resident and branch offices. In addition, of course, there is the necessity for over-all control of the organization and a knowledge of the current condition of the audit program at all times. This contact is maintained through correspondence, field visits, reports of operating activities from the districts, and through review of

reports of audits. By these and other means, we obtain uniformity of application of policies among the districts and maintain a progressively higher standard of performance. Many of the reservists returned to active duty are engaged in this top level supervisory work both at the Auditor General Headquarters and at the district headquarters offices.

I should like, at this point, to repeat the use made of the reports of audit. First, as to reports of audits within the Air Force, these are used by commanders and their staffs as a means of determining the status of accounts, the quality of personnel keeping the records, the integrity of individuals involved in transactions, and as a means of developing improvements in the operation of their activities. The audit reports in connection with procurement are generally delivered promptly to contracting officers or contract negotiators. In the case of cost reimbursement-type contracts, the contracting officer uses the statement of the auditor in considering the contractor's claim for reimbursement. Very few differences of opinion arise between the auditors and contracting officers on these contracts. On the price revision or price redetermination form of contract, the auditors' findings are used by negotiators and procurement cost analysts as an aid in studying the contractors' statements of cost and cost proposals.

I have particularly emphasized this in order to focus your attention on the need for close cooperation between contractors' accountants and Air Force auditors, as well as other service auditors. Contractors should try to find out the accounting implications of their contracts as early as possible. They should then be able to make the records and data available with a minimum of trouble and loss of time. The less difficult the audit, the less time required and therefore the fewer men needed. Contractors can often save audit time by supplying schedules which they can prepare much faster than the auditor who may be unfamiliar with the plant or office. Sometimes the facilities, desks, lighting, and location of working space provided for auditors tend to delay the

audit work. In this emergency, when the maximum use of manpower is essential, the Air Force is constantly seeking ways to simplify procedures and get the greatest possible production from the available audit personnel.

This element of teamwork is an essential part of our capacity to get the job done. The American Institute of Accountants is to be particularly commended for its splendid cooperation in helping us to

solve complex problems of an accounting nature, and in rendering invaluable assistance in our continual search for accounting talent.

I sincerely trust that this brief picture of auditing in the Air Force has given you some conception of the problems which we face, particularly from the standpoint of manpower, and that you will continue to do all within your power to aid in this most vital program.

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